The New York Certified Public Accountant

VOL. XXII — *July · 1952* — No. 7

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BOOK REVIEWS

(Continued from page 386)

The book is divided into the following sections:

Part I, Chapters 1-3: Introduction.

Part II, Chapters 4-13: Double entry bookkeeping, adjusting entries, work sheets, statements, special journals, controlling accounts. Chapter 13 is on "Cash Control Systems."

Part III, Chapters 14-21: Accounting for proprietorships, partnerships, and corporations.

Part IV, Chapters 22-33: Accounting Theory. Accounting problems of classification, valuation, allocations, changing price levels, determination of income.

Part V, Chapters 34-37: Special Aspects of Accounting. Accounts of manufacturing businesses, affiliated corporations, consolidated statements. Auditing; Tax and Payroll Accounting.

Part VI, Chapters 38-39: Conclusion. Chapter 38 deals with the Analysis of Accounting Statements, and Chapter 39 with the Validity and Utilities of Accounting.

Commendably, the author takes a positive position on cash discounts and shows them as deductions from sales and purchases (p. 151-153). The all-inclusive statement of income is illustrated on page 386.

All in all this reviewer feels that Professor Ascher has produced a very creditable book. It is modern without question. The attention which he gives in Part III to accounting theory is especially deserving of commendation.

The 39 chapters of the book are accompanied by approximately 215 problems and 141 questions. None of the problems can be considered as "long" and this feature should appeal to many instructors and students alike.

ARNOLD W. JOHNSON
Syracuse, New York

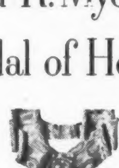
First Year in Accounting (Fourth Edition)

Volume I (Fundamentals). 267 pages. $3.50. Volume II (Principals) 302 pages. $3.50. By Davil Himmelblau. THE RONALD PRESS COMPANY, New York, N. Y., 1952.

This is a two-volume, looseleaf, textbook intended to serve the first-year needs of both accounting and nonaccounting students in schools of business administration. The materials of the two volumes emphasize heavily the mechanics and techniques of accounting.

There is a concerted endeavor to encompass a thorough treatment of accounting materials and to do so with economy in the use of student time. Accordingly, the discussions are brief, concise, and condensed.

(Continued on page 448)



THE NEW YORK CERTIFIED PUBLIC ACCOUNTANT

EMANUEL SAXE, *Managing Editor*

The matters contained in this publication, unless otherwise stated, are the statements and opinions of the authors of the articles, and are not promulgations by the Society.

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Comments on Staff Training

By KENNETH B. WACKMAN, C.P.A.

Staff training takes time; there are no short cuts or magic methods. The author suggests an approach to the problem which is somewhat different from the usual classroom technique of staff training, and which has particular application to the smaller practitioner.

IT is obvious that staff training is an increasingly significant and necessary function in the administration of an accountant's practice. The only thing we accountants have to sell is accounting knowledge and experience, and the standard of service which we offer to our clients is in direct relationship to the competence of our staff. Even with the careful application of modern techniques of testing and selecting personnel, it is still necessary to nurture the new employee and to develop his abilities in such a way that they mesh with the efforts of the organization as a whole.

KENNETH B. WACKMAN, C.P.A., is a member of the Society and of its Committee on Administration of Accountants' Practice. He is also a member of the American Institute of Accountants and of the National Association of Cost Accountants. Mr. Wackman is a partner in the firm of Alexander Grant & Company.

This paper was presented at a technical meeting of the Society held on November 13, 1951, under the auspices of the Committee on Administration of Accountants' Practice.

In considering the subject of staff training it might be well first to explore its objectives. In my research on this subject, I ran across an article written twenty-nine years ago by John R. Wildman for the Journal of Accountancy,* in which he stressed the importance of individual training with particular emphasis on the so-called personal attributes. He devoted considerable comment to "cleanliness, neatness, careful grooming," as well as "honesty, integrity, dependability and social conduct." He felt that continuous training was necessary to correct such bad habits as "tardiness, familiarity, unmannerliness, and carelessness." The field of accountancy has progressed immeasurably since 1922, and with it have developed wide and diversified responsibilities. Although staff training in our present day would not minimize the importance of personal attributes, we find that its objectives have broadened considerably since the early twenties.

* "Training Young Accountants" by John R. Wildman; *The Journal of Accountancy*, June 1922.

For the purpose of this discussion, let us consider the objectives of staff training to fall into three main classifications and see what methods apply logically and practically to each. The three classifications I have in mind are as follows:

Personal training;
Technical training; and
Organizational training

In considering *personal* training for the staff man, we think of such things as habits, general conduct and personality. *Technical* training emphasizes the development of the individual's technical ability and specialization, such as report writing, system work, cost work or income tax work. *Organizational* training refers to the orientation of new men in the organization, the standardization of procedures and the most effective use of the manpower you have available.

Personal Training

When we approach staff training in the light of the objectives just mentioned, it is apparent that there are many methods which can be applied. Consider the so-called personal training; this can be most effectively accomplished on an individual basis rather than a group basis. Suppose you want to give a staff man the benefit of your observations and criticisms, for instance, in a case where he has demonstrated a deficiency in his attitude to the client's personnel. It is not very likely that you will be effective in correcting that man's difficulty if you call all your staff together and give a general lecture on client relationship. If you take a specific example, pointing out the weaknesses of performance and suggesting the way to solve the problem, the individual staff man will benefit immeasurably.

Another method of personal training, as it can be applied on an individual basis, is to arrange for your staff man to attend conferences with the key personnel of the client when accounting and related matters are discussed. If you try sincerely to have your man meet the client on a basis of full responsibility, as far as practicable, you will instill in him a feeling of confidence and present a real challenge to him to meet his responsibilities in a dignified and professional manner. Such an approach is also important and helpful in building a better understanding and acquaintance between your organization and that of your client, which will be of constant benefit in the administration of your engagements.

It is a good policy to lunch occasionally, but with deliberate regularity, with each of your staff men and direct the conversation towards a problem with which you have been mutually engaged. He will appreciate thrashing the thing out first-hand, and will be more apt to ask questions and develop his thinking on the subject than he possibly could in a group discussion.

When we begin to think of the problem in this way, it becomes apparent that staff training does not have to await the time when a formal program can be developed and your staff assembled to hear words of wisdom from partners and senior representatives of your firm.

Technical Training

The second classification of staff training; namely, the technical training, is more adaptable to group methods than is personal training. In fact, if your staff is of any size at all, the group training method is probably the most satisfactory way of disseminating technical information. We are all generally familiar with the methods applied by most of the large firms. Some of the large, national firms have a formal course of instruction presented over two or three months during the off-season, at which time they bring men from all their offices to a central location and hold regular classes, examinations, and so on. Other firms use modifications of this technique, arranging more or less formal staff training ses-

sions held, possibly, one night a week over a period of six or eight weeks; or, in some cases, as in our firm, they hold concentrated sessions for two or three days in which an attempt is made to cover all phases of staff training that are deemed to be important.

Another method used by some firms is to schedule, more or less regularly, specialized meetings on timely topics, such as a new excess profits tax law, wage and hour regulations, the LIFO method of pricing inventories, and similar subjects. By and large, the techniques applied in this type of training follow the conventional pattern of lectures by partners, supervisors or qualified senior staff men. In many cases the lectures are supplemented by the use of work sheets so that the trainee can have the opportunity of working out a particular form or set of forms, and thus learn by doing.

In our firm last year, we abandoned the lecture method in favor of group discussions for technical staff training. Various subjects and phases of an audit engagement were assigned to teams, each consisting of a senior member of our staff and a junior member. Together they performed research and prepared the material for presentation before the entire group. Usually the actual discussion was led by the senior member of the team. We found that this method stimulated a certain amount of interest and proved beneficial in that, in preparing the material, the men had to go over that particular subject rather carefully. We found that not all of the men were equal in their thoroughness of study and their effectiveness in presenting the subject to the group and, for that reason, we did not consider the experiment fully satisfactory. I suppose the way to improve upon this method would be to have more or less formal papers prepared and submitted for approval to the staff manager and, in that way, coordinate the material and set a standard for performance.

I suspect that many accountants feel that all this business of group sessions, formal lectures, *et cetera,* is a fine thing but is not possible or applicable in their case. I think most of us find it very difficult to stop servicing our clients and concentrate on a staff training program such as we have just been discussing. It seems to me, therefore, worthwhile to suggest some techniques which are practical and logical for the smaller practitioner to use to improve the technical knowledge of his staff men. Practically all literature on staff training emphasizes that colleges by and large are not able to turn out fully trained accounting technicians. Therefore, whether we are large or small, we should not assume that we can completely ignore the problem of technical training.

Mr. Wildman in his article written in 1922, to which I previously referred, came to the conclusion that the most important method of staff training was on-the-job training and I suspect that a great deal can be done even in the present day in this respect. This is a type of training which can be employed by consistent thought and application to the problem. It requires nothing more than a realization that your staff man can learn by your experience and techniques of auditing if you will deliberately take the time and effort to transmit them to him.

Since it is not always possible to do as much as we might desire in respect to on-the-job training, there are other supplemental techniques which do not require formal training methods, but which all serve to accomplish the general objective of improving the technical capabilities of the staff man. Some firms follow the practice of having the senior and the staff assistant, or assistants, sit down before the beginning of an engagement and review together the working papers of that specific engagement for the last year and the proposed program for the current year. The senior is in a position to point out some of the peculiarities and problems of this particular engagement, thereby provid-

ing an opportunity for the assistant to see the whole picture of the engagement. This gives the assistant a better understanding of the relationship and importance of the particular phase that he may be performing, even though this phase may be the most routine part of the job. The effectiveness of this approach depends a great deal upon the cooperation and sincerity of the senior or supervisor who is doing the job. If the senior appreciates that his success in the performance of the job will rest to a great extent upon the cooperation he gets from his assistant, he will make a conscientious effort to instill in the staff man an enthusiastic interest.

There are other methods of technical training which can be very effectively applied from time to time. For instance, you may have an accounting problem that requires research. You may think you know the answer, but you would like to check a recognized text or one of the American Institute Bulletins for confirmation. Rather than do that yourself, request that your staff man make his own research on the subject and prepare a draft of a letter to the client, or a memorandum for the files. This will give you an opportunity to observe the ability of the man to read critically and precisely and, if he writes a report or memorandum, to observe whether he is able to write correctly and fluently. When you have his report, you are in a position to make constructive and specific criticisms, if necessary, of his work and conclusions. That type of staff training, although it is almost on an individual basis, can be particularly effective and relatively easy to administer.

Another informal method of technical training is to provide your staff with some of the commercial services on tax matters, SEC regulations, wage and hour regulations, and American Institute of Accountants' Bulletins. It is important that the men be urged to use these services, that they have them available, and be allowed time to study them. Some of us from the old school may cling to the idea that tax letters and various technical bulletins should be read on the way to and from work and at home, but I am afraid that we will reap greater benefits if we consider that keeping abreast of current accounting and tax literature is part of the job, to be performed during the regular working day. That does not necessarily mean that every member of the staff must get all the various bulletins and releases; but obviously men who work with tax problems should receive the tax bulletins and those who handle accounts involving SEC regulations, et cetera, should make it their business to keep abreast of all releases on those subjects.

Staff men should be encouraged to participate in New York State Society committee work and in meetings of the National Association of Cost Accountants, as well as tax forums, and to read regularly the publications of these organizations. Those who are so inclined should be encouraged to submit material for publication in accounting magazines. They cannot expect to have everything published that they submit, but they should be encouraged to prepare material anyway. If it serves no other purpose, it can be used within your own organization. Staff men should be encouraged to attend appropriate business shows and exhibits. All these things tend to improve a man's technical ability and deliberate effort should be made to emphasize to the individual the importance of technical proficiency.

Organizational Training

The last, and possibly the most important, objective of staff training is organizational training. I would like to suggest that organizational training will be the most important tool for the effective use of our manpower in our present situation. We are all aware of the difficulties encountered in obtaining personnel and the problems of retaining personnel. Between these two extremes, the effectiveness of our utiliza-

tion of man and woman-power may well spell the difference between success and failure. We are not all going to be able to obtain the very personnel that we should prefer to have. Only by consistent development and intelligent direction of our individual staff men into the specializations which interest them most, and in which they are most capable, will we be able to solve the manpower problem.

The cornerstone, of course, of organizational training is the preparation of standard procedural manuals. In our firm we utilize a standard statement-presentation manual which covers the majority of types of financial and operating statements. It prescribes the firm's policy in the matter of statement classification and terminology; it covers certificates, and exceptions and qualifications to be used in our certificates, in applicable cases. It is a great time saver in the preparation of our reports by the staff man and their review by our review department.

If you do not have an organizational manual which formalizes your procedures and you do not know when you will find the time to prepare such a manual, you might consider issuing a series of bulletins or memoranda covering the various aspects thereof. You might, for instance, prepare a brief bulletin on cash audit procedures. That would be a start; maybe next week, or next month, you will want to add another on accounts receivable confirmation procedures, and so on. You will find that in a relatively short time you will have the beginnings of a staff manual which will be very helpful (particularly if you grow or expand) in standardizing the procedures and policies of your firm.

When you operate as an individual practitioner, your decision is final and it is not necessary to confer or worry about what someone else would do. When you get several men on the staff, you find that there can be a lot of disagreement on various aspects of auditing procedure, statement presentation, and the like, and that a great deal of time can be lost unless somebody formulates an approved standard method of presentation. You cannot possibly use the manpower of your organization effectively unless it operates under some more or less formal directions. This becomes particularly important, I think, when we consider that during this period of war time economy and of more or less general shortage of qualified accountants, there will unquestionably be considerable personnel turnover. Our problem may not be so much the technical training of a raw recruit as it will be the articulation and integration of the abilities and experience of men, with possibly senior and supervisory qualifications, who are new to our organization. The background of these men will be varied and they will have developed certain personal techniques and attitudes on auditing procedures, statement preparation and the like. To coordinate the activities of the whole organization and to advise your personnel exactly what you expect, with particular emphasis upon consistency and standardization, it will be necessary to formalize as many procedures as possible in an operating manual.

Finally, of course, under the general subject of organizational training, too much emphasis cannot be placed upon the importance of convincing your supervisors and senior personnel of their responsibility, not only for the performance and completion of the engagement, but for the training of junior men. If they can apply their experience and knowledge to instill enthusiasm and confidence in the younger men, a great step has been taken towards coordinating your entire personnel into an effective and productive unit.

Obtaining Accounting Personnel

By SIDNEY LICHTER, C.P.A.

Hiring the right employee is always an important function. This paper briefly discusses how this can be accomplished, emphasizing the problems of the smaller accounting firm.

THE hiring of the right man for the job is always an important task, whether or not there is a shortage of manpower. Employing people who are not productive or who have undesirable characteristics is expensive in both time and money. Such persons will have to be replaced, and the time and expense of hiring and training will have to be expended again.

At the present time, the demand for accountants is outrunning supply. There appears to be a definite shortage of juniors and seniors. From all indications, this shortage will become more severe. Juniors are scarce because the Armed Forces are absorbing the young men who normally go to college and, also, those who are graduating. Seniors are scarce because they are gravitating to private industry in search of higher compensation and, also, because they are more in demand due to the complexities of today's work.

Because of this manpower shortage and also the pressure of work today, the staff that remains has to assume more responsibility and carry more of the burden. It is, therefore, doubly important to have a competent staff. Having such staff is dependent in the first instance upon hiring the proper man.

The hiring of an employee is a twofold problem: (1) obtaining or attracting desirable and qualified applicants and (2) the selection of those who are most desirable and best qualified.

SIDNEY LICHTER, C.P.A., partner in the firm of Kipnis & Karchmer, C.P.A.'s, has been a member of the Society since 1943. He is a member of the Society's Committee on Administration of Accountants' Practice and the Committee on Monthly Audits.

This paper was presented by Mr. Lichter at a technical meeting of the Society held on November 13, 1951 under the auspices of the Committee on Administration of Accountants' Practice.

Sources for Obtaining Personnel

The usual sources for obtaining applicants are newspapers and trade journals (in the "Help Wanted" and "Situations Wanted" sections), college placement bureaus, employment agencies (both private and public), and through employees of the firm. I believe that we are all acquainted with the operation of each such source. However, I should like to bring a few important points to your attention.

No matter which medium is used, the prospective applicant should know as much about the position as possible before he comes for the interview. In particular, he should know about any objectionable features of the job, such as travel, night work, temporary status, etc. If the job is advertised in the papers, the contents of the ad should include these matters or, if an agency is used, it should be informed thereof. This policy will save many hours of interviewing applicants who cannot take such jobs or who do not want them. On the other hand, if there are desirable features, these should also be indicated, in order to obtain as large a response as possible.

Another source for obtaining juniors and, also, temporary help is the college that has an internship training period as part of its curriculum. Such institu-

tions usually allow their students to be employed by C.P.A. firms in the senior year for a period of approximately three months. Using this source will give manpower at the time most needed, usually during the tax period. It also enables the firm to evaluate the men under actual working conditions, but with no obligation for hiring after the training period comes to an end. Thus, the firm has a pool of juniors during the period when most needed, and also has the opportunity to select juniors who have proved themselves for permanent employment.

The employees working in your firm are another very good source for obtaining new personnel. If the firm is one for which the employees like to work and of which they think highly, the present employees can very often recruit applicants. They usually have friends in the field and know which ones are looking for a job or are not happy where they are employed. I would suggest that the better men of the firm particularly be asked to recommend prospective applicants.

Employment agencies, in addition to being a source for securing employees, have another useful function: the screening of applicants. Therefore, the agency used should be given a fairly detailed description of the type of employee desired. Usually, they will send only the type sought, saving much interviewing time.

An agency also does screening for the applicant, especially in a period of manpower shortage when the applicant is apt to indicate the type of firm he desires to work for. This saves him the time and effort of answering innumerable ads and going for interviews to firms for which he would not work.

This screening process depends, however, on the availability of applicants and employers. If there is a shortage of applicants, the agency does not and cannot screen as well as when the supply is abundant. It informs the prospective employer that it has only a few applicants and may send what it has. By the same token, the employer, realizing the situation, is often glad to see those available in the hope that one might be desirable.

What the Smaller Firm Can Do

The methods or media used in obtaining desirable applicants should, and probably would, differ depending on the type of employee being sought and the size of the firm.

For example, juniors would probably be sought at College Placement Bureaus, while seniors would not. Newspapers could be used for both, but the ads in trade journals would probably be used for seniors rather than juniors. Large firms interview college seniors before graduation, informing those hired to report after graduation. They may also place standing orders with employment agencies to refer any and all eligible applicants. Smaller firms usually cannot do either and hire only when and if an opening occurs.

It would, therefore, appear that the larger firms have the inside track in obtaining the best of the college graduates. In addition, they offer more compensation and have the glamour of a big name, a truly attractive combination.

However, this should not discourage the smaller firms from putting in their bids. The very fact that they are not large sometimes has decided advantages. A survey conducted by the CCNY Placement Bureau among graduates, CPA firms, and college instructors in accounting indicates that the medium-sized firm is most desirable and the most desired. This survey characterized the medium-sized firm as having from seven to fifteen employees.

The desirability arises because employees in such firms have more opportunity to perform all the accounting and auditing functions, and to perform them sooner. They usually are not confined to a few clients and they won't remain juniors or checkers, doing routine footings and extensions, for years. The smaller or medium-sized

firm should fully exploit this point of experience with all applicants, and the interviewer should honestly explain the progress that the qualified applicant may make.

To attract personnel, the smaller firm should also consider offering "fringe benefits" such as free group insurance, hospitalization plan, etc. These benefits have a definite attraction at hiring time. Usually, these inducements can also be very beneficial to the principals directly. In most plans, the principals are included and the full premiums are deductible for tax purposes. With the high tax rates in effect today, the cost is much lower than the actual permiums paid.

Selection of the Applicant

Selecting the right man involves the gathering of data which is both pertinent and necessary. The knowledge obtained from these data should enable the interviewer to appraise the individual's characteristics and evaluate his future worth in terms of his desirability, productivity, skill, accuracy, speed and other variables. Among the devices used to obtain these data are the application blank, the interview, aptitude and achievement tests, checklist of characteristics and personality, and references.

In choosing any one or all of these devices, a cost in terms of time and money is involved. Such cost, however, is usually trivial when compared to the cost which results from hiring the wrong employee. Of course, the extent to which the various devices may be used will often depend upon economic conditions: When there is a shortage of manpower, one may find that applicants will not spend the time taking various tests; conversely, when there are many applicants, more tests or methods may be used in order to eliminate the less desirable applicants.

Simple Methods for Obtaining Information About the Applicant

The simplest and perhaps most important means of obtaining the factual information is through the application blank. It should be as short as possible and still supply all the necessary information; individual items should be brief, impersonal and unambiguous. The form should be filled out even when the applicant has sent in a letter giving his qualifications. This should be done for two important reasons: first, to determine the legibility of the handwriting of the applicant; and secondly, because many applicants list different qualifications in their letters replying to different ads.

Equally important is a checklist which gives the interviewer's objective observations of the applicant. This checklist should cover the manners, appearance, dress, bearing, speech, nervous habits and other items of descriptive nature.

Although many firms use different methods for screening applicants, I believe that the smaller firm without a personnel department or personnel man will find that the application blank, coupled with the interview, will be the easiest and most fruitful. The application blank will, among other things, give an indication of the scholastic background and also the length of experience. It will also show the fellow who jumps from one job to another, indicating, perhaps, lack of stability and loyalty.

The interview itself, when conducted skillfully, will more fully indicate the background. The applicant should be questioned about the type of work performed, clientele served, scholastic interests, etc. The applicant should also be asked how he handled or would handle certain situations or problems.

With this line of questioning, a picture can be obtained of what the applicant has done and can do. It also affords an excellent opportunity to judge his ability to think, both intellectually and professionally, as well as his tact, amiability, persuasiveness, speech, etc. Of course, the usefulness of such forms and procedures is depend-

ent upon the interviewer's ability to make accurate and objective observations and to come to a correct conclusion.

To aid the interviewer, aptitude and achievements tests are used by various firms. The American Institute of Accountants has developed a series of such tests and anyone who wants to use them may do so at a nominal cost. It should be remembered that these tests are not 100% accurate, and the interviewer should only use them as a guide.

The Importance of Scholastic Records and Personality

In the same vein, undue weight should not be given to scholastic records. I believe that it is unwise to limit the interviewing solely to those with the highest marks. All too often, very capable men are not interviewed because their scholastic records, while good, are not of the highest. Very high scholastic achievement, or the passing of certain tests with high grades, is naturally desirable. Some firms feel, therefore, that the higher the marks in school the better the man. However, brilliance in school does not always mean that there is the ability to translate the technical or scholastic information into working knowledge and successful performance on the job.

Heavy emphasis should be placed on the personality of the individual under consideration. By personality, I mean the applicant's ability to deal with people, including clients, to assume responsibility, to think clearly, his character and his cultural background. This personality factor is very important, as the men we hire and send on audits are our representatives and, as such, the impressions they create determine the opinions people will have of the firm.

Information the Applicant Should Have

Although an interview is generally thought of as time when the employer picks the employee—it should also be remembered that it is the time when the employee picks the employer. It is, therefore, important to find out what the applicant wants and whether he desires and understands the type of firm he might enter. Too often, an applicant is hired and then finds that he is unhappy in the firm because of certain conditions. Invariably, he soon leaves and the problem of hiring starts all over again.

Before an applicant is hired, the interviewer should have a very frank discussion with him about his place in the firm, what type of work he will do in the near future, the progress he can make and, if possible, the future to which he may look forward. The working conditions of the firm should be described fully, including working hours, overtime and its computation, Saturday work, travel, type of clientele, concentration of clientele, etc. It is on this basis that the firm will have a better chance of obtaining personnel that will at least be happy at the start. In the long run, such a policy will tend to reduce personnel turnover.

Conclusion

In short, the desirable employee is the one who is able to perform his job with speed, accuracy and efficiency, represent the firm to the client to good advantage, be well liked by his fellow workers and the firm's clients, and be happy with the position. It is this employee that our screening devices must enable us to choose from any number of applicants.

This requires skill, good judgment and patience and, above all, a thoroughly interested and objective attitude on the part of the one selecting the personnel.

Tax Accounting for the Real Estate Operator

By MORTON GELLER, C.P.A.

This paper considers some of the tax problems inherent in the management of business real estate, subsequent to its acquisition, but prior to its voluntary disposal.

Depreciation

Depreciation, as a deduction from ordinary income, has currently assumed an importance which is recognized by the Revenue Act of 1951.[1] The new section of the Code[2] denies capital gain benefits to transfers of depreciable property between husband and wife as well as between an individual and a corporation which he "controls." In commenting on this section, the Staff of the Joint Committee on Internal Revenue Taxation explained that this new provision prevents the substitution of a capital gains tax, paid currently, for ordinary income taxes, paid over several years, on the same amount of income.[3] The Joint Staff stated, "The differential between the capital-gains rate and the ordinary rates make such a substitution advantageous. . . ."[4]

This deduction is particularly important in the real estate field where depreciation may often amount to 15% of rental income and apply to as much as 80% of all assets. If a gain is recognized on the sale or other disposal of real estate,[5] with the exception of property held for sale primarily to customers, the benefit of the capital-gain tax limitations[6] is available.[7] Real estate dealers might find it advantageous to take the largest possible depreciation deductions, since present day income tax rates are near record high levels[8] and sales in the future might be made at a time when lower rates are effective.

Since the real estate operator may be presumed to manage property used in

MORTON GELLER, C.P.A., has been a member of the Society since 1946. He received the degrees of B.B.A. from The School of Business and Civic Administration of The City College of New York and LL.B. from New York University. Mr. Geller is presently serving as Chairman of the Society's Committee on Real Estate Accounting and formerly served as a member of the Committee on Administration of Accountants' Practice. He is also a member of the American Institute of Accountants. He is a partner of Geller & Geller, CPAs, New York City.

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1 IRC § 328.
2 IRC § 117(o).
3 Staff of the Joint Committee on Internal Revenue Taxation, Summary of the Revenue Act of 1951, Part IV, No. 26.
4 Ibid.
5 IRC § 112.
6 IRC § 117(c); Alternative capital gains tax increased from 25 per cent to 26 per cent by Revenue Act of 1951, § 322, effective for corporations with taxable years beginning after March 31, 1951 and for individuals whose taxable years begin after October 31, 1951.
7 IRC §§ 117 (a)(1) and 117(j).
8 Revenue Act of 1951, §§ 101 and 121.

trade or business, or property held for the production of income, he is, of course, entitled to a reasonable deduction for depreciation.[9] The important question is how much depreciation may be deducted without exceeding the limits of a reasonable allowance?

Depreciation is a deduction permitted annually for the exhaustion or wear and tear of business property, so that the aggregate of the amounts so allowed, plus the salvage value, will, at the end of the useful life of the property, equal its cost or adjusted basis.[10] Since real estate operators usually acquire their property by purchase, this purchase price should be allocated over the useful life of the property.

Straight-Line Depreciation

The most common method of apportionment in use by taxpayers is the straight-line method, which permits the cost to be deducted in equal annual installments over the period of the estimated useful life of the property.[11]

The grouping or classification of depreciable assets varies through all degrees of refinement, from a single composite account to the extreme limit of item accounting which requires a separate account and reserve for each single item of equipment.[12] "Classified Accounts" grouping of depreciable assets is the most advantageous for the real estate operator. This entails a separation of the cost of depreciable assets not forming an integral part of the building into such units as ranges and refrigerators, heating equipment, elevators, furniture and furnishings, etc. This segregation will result in a larger immediate depreciation deduction, because these assets may be written off over a period of five to twenty years, whereas the building may be written off over a period as long as fifty years. In addition, if the composite grouping of all depreciable assets into one account is adopted, building equipment may be replaced several times before the depreciation deductions exhaust the units originally installed. Usually no loss is permitted by the Treasury Department on the retirement of a particular asset under the composite rate because they insist that the rate includes an allowance for probable retirements.[13]

Bulletin "F," revised by the Bureau of Internal Revenue in January, 1942, contains estimates of the useful lives of depreciable assets. These estimates are merely guides and averages from which the correct rate may be determined for the particular property in question.

Declining Balance Method

Another manner of computing depreciation is the "declining balance" method, which involves the use of a depreciation rate equal to 150 per cent of the normal straight-line depreciation rate applied against the net depreciated value of the property at the beginning of each year.[14] During the early portion of the life of the asset, larger annual deductions are allowed than under the straight-line method. The disadvantages of this method in failing to permit full recovery of cost, and in reducing depreciation deductions in later years, make its adoption advisable only

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[9] IRC § 23(1); Reg 111 § 29.23(1)-1 through 5.

[10] Bureau of Internal Revenue Bulletin "F" (Revised January, 1942); "cost basis" explained by IRC § 113(a); "adjusted basis" for depreciation defined by IRC § 114(a) as the basis provided by IRC § 113(b) for the purpose of determining gain upon the sale or other disposition of property.

[11] Bureau Bulletin "F"; R & J § 45.01(4).

[12] Bulletin "F" contains a detailed explanation of the four basic methods of separating the depreciable assets into groups.

[13] Ibid.

[14] IT 3818 (CB 1946-2, 42); Seghers, *Depreciation*, 83 Journal of Accountancy 113 (1947); Mayer, *Declining Balance Depreciation*, 25 Taxes 162 (1947).

in the expectation of short-term ownership.

Other Depreciation Problems

In calculating the remaining useful life of a building, care should be taken to ascertain the period that has elapsed since the construction of the building and the installation of the building equipment.

In adopting a plan for computing depreciation, it need not conform to the procedure or rates suggested by the Treasury Department. Other rates are possible, as long as they are reasonable; however, operating conditions as they are known to exist at the end of the taxable period must be taken into consideration. The burden of proof for deviations from the regulations will rest upon the taxpayer to sustain the deduction claimed.[15]

Extraordinary Depreciation

It is recognized that under certain conditions property may be subject to extraordinary depreciation because of unusual operating conditions.[16] It is true that most of the decisions on this point refer to depreciation of machinery in industrial plants, but the reasoning in these cases may be applied to real estate.[17] The burden, of course, is on the taxpayer to prove by a preponderance of evidence that he is entitled to a larger deduction.[18] Although it may be difficult to prove, it might be possible to show that real estate is not being properly maintained because of rent controls, material shortages, inexperienced employees, etc.

In determining the useful life of a depreciable asset, the depreciation deduction not only provides for the physical life of the asset, but also for the economic life.[19] This is known as "obsolescence" and is particularly applicable to real property.[20] In allowing a useful life shorter than the physical life of an asset, the following factors have been mentioned: Changed neighborhood conditions, construction of more modern hotels, change in character of theatre business and increased competition, and the special nature of banks and office buildings.[21]

Depreciation to Life Tenant

An interesting question has arisen recently with respect to the depreciation deduction allowed to the life tenant of real property. In one case,[22] a life tenant demolished virtually unproductive real estate. At her own expense, she then erected an income producing property. At the time, she was 73 years of age and had a life expectancy of 7.3 years, but the property had a life of 50 years. The life tenant sought to depreciate the property over the seven-year period, but the Commissioner's claim of a 50-year life was sustained by the Tax Court. The court held, based

15 Mim 4170 (CB 1936-2, 148); Reg. 111 § 29.23(1)-5; Uncasville Mfg. Co. v. Comm'r, 55 F(2d) 893 (2nd Cir. 1932), cert. den. 286 US 545 (1932); Jewett & Co. v. Comm'r, 61 F(2d) 471 (2nd Cir. 1932).

16 Cumberland Glass Mfg. Co. v. United States, 71 Ct. Cl. 44 (1930).

17 Wilkes-Barre Lace Mfg. Co., 1 BTA 467 (1924) (Repair parts unobtainable—rates doubled); Champion Coated Paper Co., 10 BTA 433 (1928) (new and inexperienced employees—rates increased by 2 percent).

18 See note 16, supra: Brampton Woolen Co., 18 BTA 1075 (1930).

19 IRC § 23(1).

20 Iron Age Improvement Co., 4 BTA 305 (1926) (Acq.); (hotel allowed 5 per cent depreciation on evidence it would become obsolete within 20 years); 379 Madison Ave., Inc. v. Comm'r, 60 F(2d) 68 (2nd Cir. 1932), (Changed conditions in the neighborhood of the building evidenced that the present building would be valueless in 20 years and before the expiration of a 41 year lease); First National Bank in Mobile, 30 BTA 632 (1934) (Acq. CB 1934-2, 7) (an office building has a shorter economic life than physical life); Northern Hotel Co., 3 BTA 1099 (1926) (Acq. CB 1927-2, 5); Graeper v. Comm'r, 27 BTA 632 (1933) (Acq. CB 1933-1, 5).

21 Ibid.

22 Margaret Penn, 16 TC —, No. 186, June 29, 1951; cf. Caroline T. Kissel, 15 BTA 705 (1929).

upon the wording of the statute,[23] that the life tenant shall be allowed the deduction for depreciation in the same manner as an absolute owner. The owner in fee is allowed a deduction based upon the useful life of the property without relation to his normal life expectancy.

Since depreciation may vary from year to year, it should not be claimed automatically each year, but actual facts should be examined. This is particularly important at the present time when properly increased depreciation deductions will offset real estate income, subject to very high tax rates.

Depreciation of Leasehold Improvements

Where real property has been leased, the lessor is entitled to a depreciation deduction in the usual manner for all improvements which exist at the time the lease is entered into, as well as those improvements which are placed on the property by the lessor as a condition of the lease.[24]

Where the lessee is to restore the property unimpaired and in its original condition, neither the lessor nor the lessee is entitled to depreciation during the term of the lease.[25] If, at the termination of the lease, the lessee is required to restore the premises, the expenses in doing so are allowable deduction for the year in which paid or incurred.[26]

If it is desired that the lessor be permitted to deduct depreciation during the term of the lease, it would be wise to add to the provisions requiring the lessee to keep the property in good repair and to return the property in its original condition, an exception for exhaustion or ordinary wear and tear.[27]

The lessee is entitled to depreciation for improvements upon leased property.[28] If the improvements are to revert to the lessor on the expiration of the lease, they may be written off over the term of the lease or the useful life of the property, whichever is shorter.[29]

Where the leasehold period governs the depreciation deduction for the lessee, generally the possibility of renewal options is disregarded.[30] Where, however, it appears that there is reasonable certainty that a lessee will exercise a renewal option,[31] the lessee's improvements will be depreciated over the remaining term of the initial lease plus the term of the renewal or the life of the improvements, whichever is the shorter period.[32]

An examination of the principles pertaining to lessee's leasehold improvements indicates that if a lessee can justifiably divide a contemplated lease into an original term with an option

[23] IRC § 24(1).

[24] Weiss v. Wiener, 279 US 333 (1929); Gulf, Mobile and Northern R. R. Co. v. Comm'r, 83 F(2d) 788 (5th Cir. 1936), cert. den. 299 US 574 (1936); Alaska Realty Co. v. Comm'r, 141 F(2d) 675 (6th Cir. 1944).

[25] Georgia Ry. & Electric Co. v. Comm'r, 77 F(2d) 897 (5th Cir. 1935), cert. den. 296 US 601 (1935); Comm'r v. Terre Haute Electric Co., 67 F(2d) 697 (7th Cir. 1933), cert. den. 292 US 624 (1934), GCM 11933 (XII-2 CB 52, 1933).

[26] Frank & Seder Co. v. Comm'r, 44 F(2d) 147 (3rd Cir. 1929); IT 2970 (XV-1 CB 145); OD 516 (2 CB 112, 1920).

[27] St. Paul Union Depot Co. v. Comm'r, 123 F(2d) 235 (8th Cir. 1941); Helvering v. Terminal Railroad Assn. of St. Louis, 89 F(2d) 739 (8th Cir. 1937); Forrester Box Co. v. Comm'r, 123 F(2d) 225 (8th Cir. 1941).

[28] Reg 111 § 29.23(a)-10.

[29] Duffy v. Central R. R. of New Jersey, 268 US 55 (1925); Charles C. Lewis Co. v. United States, 14 FSupp 471 (DC Mass 1936); I. G. Zumwolt, 25 BTA 566 (1932).

[30] Reg 111 § 29.23(a)-10; Bonwit Teller & Co. v. Comm'r, 53 F(2d) 381 (2nd Cir. 1931), cert. den. 284 US 690 (1931).

[31] Pittsburgh Union Stock Yards Co. v. Comm'r, 46 F(2d) 646 (3rd Cir. 1931); Standard Tube Co., 6 TC 950 (1946); Leonard Refineries, Inc., 11 TC 1000 (1949); Alamo Broadcasting Co., Inc. v. Comm'r, 15 TC —, No. 73 (1951).

[32] Gladding Dry Goods Co. Inc., 2 BTA 336 (1925); Harris-Emory Co., 37 BTA 958 (1938).

for a renewal, it would be possible to write off his improvements over a shorter period than would otherwise be possible. Fact patterns to be aware of which might defeat such a plan include: 1) The original lease is for a short period and has been renewed regularly in the past.[33] 2) The tenant has made substantial improvements which he probably would not have made if he had not expected the lease to be renewed.[34] 3) The initial term is comparatively short and the option to renew is for a lengthy period.[35]

Improvements in Lieu of Rent

Unless a lessee is permitted by the lease to make certain improvements for the purpose of reducing the stated rent,[36] no income is realized by the lessor at the time improvements are made[37] or at the termination of the lease.[38]

A tax saving device may be utilized by the lessor by applying the tax principles heretofore mentioned in connection with lessee's improvements.[39] Where the lessor can rent his property at an increased rental after making improvements, it would be advantageous to lease the property at a lower rental, providing the tenant makes the improvements. If the total cost involved is no greater to the lessee, he should have no objections because his total payment will be deductible as rental expense and leasehold improvements. The lessor, it is true, receives a smaller rental income, but at the termination of the lease, the property reverts to him increased in non-taxable value. The gain if the property were sold, would be subject to capital gains rates instead of ordinary income. If the property were not sold it might then be rented at a higher value.

It is important that the terms of the lease should not indicate any intention that such improvement be in lieu of rent and of such a nature as to result in immediate benefit to the lessor. This may be the case where no rent is paid in consideration of improvements being made or where the normal rent for the original leasehold is substantially reduced in consideration for the lessee's agreement to make improvements.[40]

An interesting line of recent cases has presented the possibility of two taxpayers taking depreciation on the same asset in a leasehold situation.[41] This occurs where improvements have been erected on leased land by the lessee and the landlord dies. The lessor's heirs can depreciate the improvements to the extent that their value was included in the estate. A careful reading of the most recent decisions,[42] however, indicates that depreciation will be available to the lessor's heirs only where the life of the improvements exceeds the term of the lease, the improvements erected by the lessee must revert to the lessor on the expiration of the lease and a separate value for the improvements was includible in the deceased lessor's estate.

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33 Nachman, 12 TC 1204 (1949).

34 Olshine, 8 TCM 497 (1949).

35 353 Lexington Corp., 27 BTA 762 (1933).

36 Your Health Club, Inc., 4 TC 385 (1944); IT 4009 (CB 1950–1, 13); Reg 111 § *29.22*(b) (11)-1.

37 M. E. Blatt Co. v. United States, 305 US 267 (1938).

38 IRC § *22*(b) (11).

39 See Tax Savings in Real Estate Transactions, Bureau of Analysis, Davenport, Iowa, for various tax savings suggestions in the real estate field.

40 IT 4009 (CB 1950–1, 13).

41 Moore, 15 TC 906 (1950); Pearson, 13 TC 851 (1949), rev'd, see note 42, infra; Currier, 7 TC 980 (1946).

42 Pearson v. Comm'r, 188 F(2d) 72 (5th Cir. 1951), rev'g 13 TC 851 (1949); First National Bank of Kansas City, Trustee v. Nee, 8th Cir., June 7, 1951, aff'g 92 FSupp 328 (DC Mo 1950).

Income Problems

Much has been written concerning the conflicts between commercial accounting and tax accounting.[43a] This controversy is very much in evidence in the tax treatment of rents and related leasehold payments.

Rental Questions

Advance rentals are income when received,[43b] regardless of the accounting method. The lessee must capitalize his expenditure and deduct it in the later year to which it applies.[44] Where an additional payment is made to the lessor upon the execution of the lease and there are various stipulations under which it is to be returned to the tenant, the security is not taxable income to the lessor until his right to the security becomes absolute.[45] Since the lessee's deduction is deferred regardless of whether the payment is considered an advance rental or a security deposit, only the lessor is concerned with an election. Knowing the consequences, the lessor can control the time for taxing by an appropriate provision in the lease agreement, so that the income will be subject to the lowest possible tax.

Lease with Option to Purchase

A lease with an option to purchase is a transaction which involves many complications and serious uncertainties. If at all possible such arrangements should be avoided. The danger is that the transaction will be considered as a disguised sale for tax purposes.[45a]

The typical situation is one where rent payments are applicable against the selling price if and when the purchase option is exercised. This arrangement is very attractive from the practical business standpoint. The lessee-purchaser is entitled to a full deduction for current payments. The lessor has the advantage of spreading the payments for the property over a period of years as well as deducting current depreciation on the property and taxes thereon. Of course, each payment is ordinary income rather than capital gain.

If the agreement provides for the transfer of title after a specified number of rental payments, or gives the lessee an option to acquire title by making a small additional payment upon the expiration of the lease, or, if the periodic payments are large in relation to the purchase price, the arrangement would be subject to serious question by the Treasury Department. Payments by the lessee may be considered part of the purchase price rather than "rent".[46] The lessor's receipts may be treated as rentals and taxed as ordinary income. It is not necessary for the lessor and lessee to be treated in a consistent manner.[47]

Recovery of Prior Year's Real Estate Taxes

Under local real estate tax statutes where a tax is assessed based upon valuation of the property, refunds are frequently made because of overvaluation. The questions usually posed are: When is the recovery taxable? To what extent?

Under the general rule, where the deduction is allowed at the time the

[43a] Lasser and Peloubet, *Tax Accounting v. Commercial Accounting*, 4 Tax L. Rev. 343 (March 1949).

[43b] United States v. Boston and Prov. R. R. Co., 37 F(2d) 670 (1st Cir. 1930); Chateau Frontenac Inc., 167 F(2d) 856 (6th Cir. 1945), aff'g BTA Memo 10/20/42.

[44] Reg 111 § 29.23(a)–10.

[45] Clinton Hotel Realty Co. v. Comm'r, 128 F(2d) 968 (5th Cir. 1942).

[45a] Haverstick, 13 BTA 837 (1928); IT 1819 (II–2 CB 73); ARM 189 (I–2 CB 86); Watson v. Comm'r, 62 F(2d) 35 (9th Cir. 1932).

[46] Helser Machine and Marine Works, 39 BTA 446 (1939); Judson Mills, 11 TC 25 (1948).

[47] Goldfields of America, Ltd., 44 BTA 20 (1941).

tax is paid or accrued, the refund is taxable when it is received or finally determined, even though the original year is still open.[48]

In including this recovery as taxable income in the year received, care should be taken not to overlook the "tax benefit" rule under Section 22(b)(12) of the Internal Revenue Code. If the real estate tax deduction did not result in a reduction of income tax in the year paid or accrued, then the subsequent refund is not taxable.[49]

Lessor-Lessee Relationship

Bonuses paid to the lessor are taxable income when received,[50] but deductible by the tenant only if paid in consideration of the cancellation of the lease.[51] If the lessee's payment is in modification or extension of the lease, the bonus even though paid in a lump sum, will be deductible only over the period of the lease as extended.[52]

Where the purpose of this bonus is to cancel the lease, the lessor should bear in mind the additional tax burden of payment in one year in the determination of the amount to be received. If the payment is for the purpose of extending the term of the lease, it might be possible to spread this extra payment over the remaining life of the lease, without harm to the lessee, who will be required to prorate his payment in any event.

If it is the lessor who seeks to cancel the lease, any payment he makes to the lessee will be ordinary income to the lessee at the time of receipt.[53] The lessor, however, must prorate his deduction for such payment over the remaining term of the cancelled lease.[54] If the lessor intends to erect a new building or sell the property, such costs are added to the property.[54a]

Leasehold commissions, attorneys fees and similar expenses paid by an owner for services in procuring a tenant are deductible over the life of the lease,[55] but where the lease is cancelled before the end of the term, the unamortized portion of the capitalized cost is deductible in the year of cancellation.[56]

It seems quite apparent that the "bird in hand view" cited by Mr. Lasser and Mr. Peloubet is busy at work determining the taxability and deductibility of rent and related leasehold payments.[56a] As an almost infallible "rule of thumb," it could be said that with the exception of periodic rent payment pursuant to a lease, if a leasehold payment is received it is taxable at once, but the one paying this amount may have to defer its deduction until some future time.

Mortgage Questions

The expenses of the mortgagor for mortgage finance fees and commissions are of course, to be capitalized and written off over the period that the mortgage is to be in effect.[57]

Where a solvent mortgagor receives

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48 Mim 6442 (CB 1949-2, 11), modifying Mim 4564 (CB 1937-1, 93); Dixie Pine Products Co. v. Comm'r, 320 US 516 (1944); Security Flour Mills Co. v. Comm'r, 321 US 281 (1944).

49 Reg 111 § 29.22(b)(12)-1.

50 Hort v. Comm'r, 313 US 28 (1941).

51 Cassat v. Comm'r, 313 US 28 (1941).

52 Pig and Whistle Co., 9 BTA 668 (1927); Stephen Peabody, BTA Memo op., October 26, 1933.

53 Farrelly-Walsh Inc., 13 BTA 923 (1928).

54 Borland, 27 BTA 538 (1933); Henry B. Miller, 10 BTA 383 (1928).

54a Shirley Hill Coal Co., 6 BTA 935 (1927); Business Real Estate Trust of Boston, 25 BTA 191 (1932).

55 Andrew J. Pembroke, 70 F(2d) 850 (DC C 1934), aff'g 23 BTA 1176 (1931); Walter and Co. Inc., 4 BTA 142 (1926).

56 Manhattan Life Insurance Co., 28 BTA 129 (1933); Blanche B. Burley, Exrx., 26 BTA 615 (1932).

56a Note, 61 Harv. L. Rev. 1010, 1013-14; see Lasser and Peloubet, note 43a, supra.

57 SM 3691 (IV-1 CB 145); Lovejoy, 18 BTA 1179 (1930); Klyce, 41 BTA 194 (1940); Detroit Consolidated Theaters, Inc. v. Comm'r, 133 F(2d) 200 (6th Cir. 1943).

a reduction of the mortgage debt, and such reduction is not a gift under the *American Dental* rule,[58] income is realized.[58a] However, there is no taxable income if 1) the owner is not personally liable for the mortgage debt, or 2) the value of the property at the time of the debt cancellation does not exceed the remaining indebtedness or 3) if the transaction was intended by the mortgagee as an adjustment of the purchase price.[59]

Operating Expenses

Certain operating expenses have been selected which are illustrative of the tax problems of real estate operation.

Repairs vs. Capital Improvements

Although the rule governing the deductibility of repairs is theoretically clear, applying it to specific fact patterns causes considerable difficulty.[60] Regulations 111, Section 29.23(a)-4 provides that the cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted as an expense. Repairs in the nature of replacements, to the extent that they arrest deterioration and appreciably prolong the life of the property, should be added to the capital account or charged against the depreciation reserve. One test that might be applied to this situation is whether the particular expense to be classified merely keeps the property in an operating condition over its probable useful life for the use for which it was acquired, or prolongs the life of the property, increases its value, or adapts it to different usage.[60a] The relation between the cost of the repairs and the value of the building is not of particular significance in determining deductibility.[61]

Insurance

The accounting method used by the taxpayer is of no consequence in determining the deduction for insurance expense. Where premiums are paid for more than one year, only the pro rata portion of the premiums may be treated as an expense.[62]

Special Benefit Assessments

Special assessments, made for local benefits, which tend to increase the value of the property assessed are not deductible in accordance with Section 23(c)(1)(E). To the extent that such assessments are made for the purpose of maintenance and repairs or for meeting interest charges on such benefits, they are deductible. The burden, however, is on the taxpayer to show the allocation of the amounts assessed to the different purposes.[63]

Real Estate Taxes

In order that a taxpayer may obtain a deduction for real estate taxes, it is necessary that the tax be imposed upon him or upon property he had an interest in.[64] Weight is given to the accounting method of the taxpayer.[65] The most difficult problem arises in the proration of the tax at the time of sale. If the taxes became a lien of the owner before the title to the property had passed, only the seller may deduct the

[58] Helvering v. American Dental Co., 318 US 322 (1943).
[58a] IT 4018 (CB 1950-2, 20).
[59] R & J § 44.06(2).
[60] Winsten, *Tax Problems in Real Estate Operations,* 20 New York State Certified Public Accountant 17 (January 1950).
[60a] Illinois Merchants Trust Co., Exr., 4 BTA 103 (1926).
[61] American Bemberg Corp., 177 F(2d) 200 (6th Cir. 1949), aff'g 10 TC 361 (1948); Buckland v. United States, 66 FSupp 681 (DC Conn 1946).
[62] GCM 23587 (1943 CB 213).
[63] Reg 111 § 29.23(c)-3.
[64] Magruder v. Supplee, 316 US 394 (1942); Reg 111 § 29.23(c)-1.
[65] R & J § 41.06(2) (Cash v. Accrual Basis Taxpayer).

taxes paid,[66] even though they have been prorated and the buyer paid his share. The seller may deduct the taxes he has paid and also the taxes that the buyer has paid,[67] provided he includes the latter in his gross selling price. This, of course, increases the seller's gain on the sale. If this profit is subject to capital gains rates a definite advantage is realized because the taxes are fully deductible.

The following procedure will solve this problem: If the taxes have become a lien before sale, require the seller to pay the full amount and increase the sales price by the buyer's pro rata share. If the taxes will become a lien after the sale, require the buyer to pay the full amount and reduce the sales price by the seller's pro rata share.[68]

Carrying Charges and Taxes

A special election is available with respect to carrying charges and taxes[68a] on unimproved and unproductive real property; similarly, the same election is available during the development or construction of improvements on real property.[69]

As far as unproductive and unimproved real property is concerned, taxes and carrying charges may be capitalized one year and deducted the following year. No consistency is required until the property is improved or converted to productive use. At that time the items must be considered expenses.

In the case of development or improvement of real property, the same option exists as to capitalization or deduction up to the time of completion. All items of the same type must be treated in the same manner, but once an item has been capitalized, it must remain capitalized until the project is completed.

When expenses are incurred for the construction or improvement of a depreciable asset, it is preferable to capitalize the expenses because the taxpayer has little income during the current year and because income in subsequent years will be higher. Capitalization limits the benefit of the expense to a depreciation deduction until the property is sold. The advantage of ordinary deductions may be preserved if the taxpayer is carrying on a trade or business and is entitled to a net operating loss carry-over deduction.[69a] The election to capitalize must be filed with the tax return.[69b]

Interest Accruals

When corporate interest expense accruals are recognized by the Bureau of Internal Revenue as proper income tax deductions, the adoption of the benefits available in Section 117(f) should be seriously considered. This section provides that capital gains tax limitations[70] shall be applicable to the retirement of bonds, debentures, or notes with interest coupons attached or in registered form. Where the bond as defined in Section 117(f) provides for a steadily increasing redemption price, rather than annual interest payments, both the courts[71] and the Commissioner[72] have recognized that the redemption of bonds at maturity, or retirement prior to maturity with no intention of reissuing the same bonds, is subject to the capital gain and loss provisions.[73]

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[66] See note 64, supra.
[67] Norman Coolidge v. Comm'r, 40 BTA 1325 (1940).
[68] Tax Savings in Real Estate Transactions, Bureau of Analysis, Davenport, Iowa, II, p. 36.
[68a] IRC § 24(a) (7).
[69] Reg 111 § 29.24–5(b).
[69a] IRC § 122.
[69b] Reg 111 § 29.24–5(c).
[70] IRC § 117(c).
[71] Caulkins v. Comm'r, 144 F(2d) 482 (6th Cir. 1944), aff'g 1 TC 656 (1943).
[72] Nonacquiescence 1943 CB 28 withdrawn and acquiescence 1944 CB 5 issued.
[73] IRC § 117; McClain v. Comm'r, 311 US 527 (1941).

This decision[74] enables the bondholder to enjoy capital gain benefits upon the retirement of his bond, while the corporation on the accrual basis receives an annual deduction equivalent to interest for the increase in redemption value, since it may amortize the discount over the period of the loan even though it makes no payment until the maturity date.[75] The provisions of Section 24(c) should not be overlooked, however, in creating this indebtedness.

Closely Held Real Estate Corporations

Much of the real property in this country is owned and operated by closely held corporations.[75a] There are many advantages in this form of ownership, such as: separation of risks, limitation of personal liability from mortgage indebtedness and other claims, and occasional reduction of tax expenses. However, corporation ownership usually causes many tax complications and pitfalls.

Capitalization

For many years the capital structure of most closely-held real estate corporations was determined primarily upon the income tax advantages of corporate indebtedness over capital stock. A brief summary of the important tax consequences of a heavy corporate debt and a nominal capital stock investment are as follows:[75b]

1) Whether an individual receives dividend income or interest income, he is subject to the same tax;[76] the corporation, however, is entitled to a tax deduction for interest expense, but not for dividend payments.[77]

2) In the event the corporation liquidates, losses incurred as a result of worthless stock or bonds with coupons attached or in registered form are treated as capital losses on the return of the individual stockholder or bondholder.[78] If, however, the loss is due to a worthless debt not in registered form or not with coupons attached, it is treated as a short-term capital loss to the stockholder.[79] If the debt is incurred in trade or business, it is fully deductible.[80]

3) When an individual withdraws funds from a corporation, and those funds were originally given to the corporation in the form of a loan, no taxable income results. In the event that the funds are invested in the form of capital stock, a partial redemption, paid in a manner so that the distribution is equal to a taxable dividend, will be taxed as ordinary income[81] to the extent that it represents earnings or profits, unless a partial liquidation results.[82]

4) The capital structure may also be significant in the calculation of the credit for Excess Profits Tax on the Invested Capital basis,[83] as well as in the classification of a corporation as a Personal Holding corporation,[84] Personal Service corporation[85] or a Regulated Investment corporation.[86]

While the provision in our present

[74] See note 71, supra.
[75] Reg 111 § 29.22(a)-17; see Mandell, *Can Interest Be Income or Capital Gain*, 29 Taxes 741 (1951).
[75a] See Personal Holding Co. section, infra.
[75b] On the assumption that the stockholders can escape the dangers usually inherent in thin incorporations, discussed below.
[76] IRC § 22(a).
[77] IRC § 23(b).
[78] IRC § 23(g), (k).
[79] IRC § 23(k) (4).
[80] IRC § 23(k) (1).
[81] IRC § 115(g).
[82] IRC § 115(c).
[83] 1432 Broadway Corp., 4 TC 1158 (1945), aff'd 160 F(2d) 885 (2nd Cir. 1947).
[84] IRC § 501.
[85] IRC § 725.
[86] IRC § 361.

tax statute imposes no limitation as to the amount of interest deductible,[87] it is interesting to note that the Revenue Acts of 1909,[88] 1913[89] and 1916[90] imposed definite curbs on the amount of interest deductible by corporations without distinction as to whether widely or closely held. In the first statute, the Excise Tax imposed on corporate net income authorized a deduction for bond interest, but the amount of bonds outstanding was limited to the amount of paid-up capital stock outstanding. The 1916 Tax Law permitted a debt structure equal to twice the amount of outstanding capital stock as a basis for interest deductions. At the time of World War I, since credit was not allowed for borrowed money in determining the Excess Profits Tax, it was believed fair to permit all interest expense as a deduction for tax purposes. Although the Excess Profits Tax ended after the war, this rule was never changed.[91]

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Inadequate Capitalization

Despite the absence of restrictions upon interest deductions, we have witnessed, within the last five years, a new approach to this situation under the heading of "inadequate capitalization".[92] The general rule evolved is that where a closely-held corporation is inadequately capitalized, if the outstanding debt and capital stock is held in substantially the same proportions, the indebtedness will be treated as a capital investment.[93]

The present trend is the result of dictum in the 1946 Supreme Court decision in the case of *John Kelley* v. *Commissioner*.[94] The court stated "As material amounts of capital were invested in stock, we need not consider the effect of extreme situations such as nominal stock investments and an obviously excessive debt structure."

Publicly held corporations are excluded from the test of inadequate capitalization, because the bondholders may be distinguished as having interests separate and apart from the stockholders. They have no control over management; their investment is for a limited period and the return they receive is not dependent upon profits.[94a]

In a closely held corporation, the stockholder and the bondholder or debtors are usually the same individuals owning the same proportionate share of each investment.

The fact that more than 75% of the cases decided related to under-capitalized real estate corporations is overwhelming evidence that real estate operators should be vitally concerned with this problem.

Debt vs. Capital

The courts have been considering the realities in these cases after weighing all the factors.[95] The labeling of transactions as "debt" or "interest" by the taxpayers has not affected the decisions.[96] The Commissioner's disallowance of interest deductions and subjection of losses to capital gain limitations have been sustained by the courts, when the following factors are present:

The two major considerations are

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87 IRC § 23(g).

88 Revenue Act of 1909, § 38, 36 Stat 113 (1909).

89 Revenue Act of 1913, § IIG(b), 38 Stat 173 (1913).

90 Revenue Act of 1916, § 12(a), 39 Stat 768 (1916).

91 CB 1939-1, (Part 2), p. 94.

92 Semel; *Tax Consequences of Inadequate Capitalization*, 58 Col.L.Rev. 262 (1948); Note: Semel, *Loan v. Investment*, 5 Tax L.Rev. 424 (March 1950).

93 Ibid.

94 326 US 521, 526 (1946).

94a New England Lime Co., 13 TC 799 (1949).

95 Sam Schnitzer, 13 TC 43, aff'd 183 F(2d) 70 (9th Cir. 1950); see note, 92 supra; cf. Weldon D. Smith v. Comm'r, 17 TC --, No. 17 (1951).

96 Edward G. Janeway, 2 TC 197 (1943), aff'd 147 F(2d) 602 (2nd Cir. 1945); Erard A. Matthiessen et al. v. Comm'r, 16 TC 781 (1951); Bair v. Comm'r, 16 TC 90 (1951).

(1) inadequate capitalization and (2) proportionate owning of indebtedness and capital stock by the same individuals.[97] Other circumstances which may sway the final decision against the taxpayer are: (1) The bonds or other indebtedness have no fixed maturity date, (2) Interest is paid only when profits are made, or (3) No interest payments have been made.

In view of the trend of recent decisions, it is important that corporations adopt more realistic capital structures, so that unexpected tax assessments resulting from a non-acceptable capital organization will not seriously interfere with the operation of real estate ventures.

Despite the apparent advantages of loans or other indebtedness in the capital structure of a corporation from the tax standpoint, these debts should not be created unless they can be properly justified. If the capital stock and the indebtedness of the corporation are owned in the same proportion by the same stockholders, there must be substantial value in the capital stock of the corporation. "Substantial value" does not exist when the original investment necessary to acquire a corporate asset is not entirely classified as a capital investment.

Standards to Prove Indebtedness

If funds are required thereafter by the corporation and moneys are invested by the stockholders in the form of indebtedness, the corporation should meet the standards which identify debts, i.e. (1) Interest should be paid periodically, whether or not the corporation realizes a profit, (2) These obligations should have all the indicia of indebtedness, such as a fixed maturity date, priority or equality with the claims of other creditors, (3) All the formalities usually associated with indebtedness should be followed. Many of the problems involved may be avoided if the corporate indebtedness is owed to non-stockholder creditors[97a] or if the debt is not owed to the shareholders in substantially the same proportion as the stockholdings.[97b] If the corporation has an obviously excessive debt structure, the decisions have not definitely concluded that disproportionate holdings in stock and indebtedness are sufficient to assure recognition of the debts as bona fide obligations for tax purposes.

Although all the ramifications of this problem have not been decided, the obvious extreme situations are clear and should be avoided by advance planning.

Reasonable Salary

In computing net income, corporations are permitted to deduct ". . . a reasonable allowance for salaries or other compensation for personal services actually rendered".[98] *Botany Worsted Mills* v. *United States*[99] is the leading case interpreting this provision of the tax law. The Supreme Court stated in its opinion ". . . unusual and extravagant amounts paid by a corporation to its officers in the guise and form of compensation for their services, but having no substantial relation to the measure of the services . . . are not in reality payment for services". There is no fixed standard or yardstick by which the reasonableness of the compensation in any particular case can be measured.[100] One writer has accu-

[97] Swoby Corp., 9 TC 887 (1947) (Capital \$200—Debt \$250,000); Isidor Dobkin, 15 TC 31 (1950) (Capital \$2,000—Debt \$70,000); Mullen Building Corp, 9 TC 350 (1947), aff'd 167 F(2d) 1001 (3d Cir. 1948) (Capital \$10,000—Debt \$290,000).

[97a] The courts hold in most cases where the stockholder indebtedness is not recognized, that an outside individual would not loan money under the same circumstances.

[97b] Arthur V. McDermott, 13 TC 468 (1949); Weldon D. Smith v. Comm'r, 17 TC —, No. 17 (1951).

[98] IRC § 23(a) (1) (A).

[99] *278 US 282* (1929).

[100] L. I. Drug Co. v. Comm'r, 111 F(2d) 593 (2d Cir. 1940); J. D. Van Hooser & Co. v. Glenn, 50 FSupp 279 (DC Ky 1943).

mulated a check list of a hundred pertinent facts for a determination of reasonable compensation.[101] The burden is on the taxpayer to prove that an amount disallowed by the Commissioner was reasonable and therefore available as a deduction in computing taxable income.[102]

These general rules are, of course applicable in the determination of salaries for employees of real estate corporations.[103] Salary arrangements in a family or closely held corporation are viewed critically.[104] Since most real estate corporations are closely held,[105] these companies should give careful thought to the compensation paid officer-stockholders. Proper planning may enable corporation-employers to prove the reasonableness of their salary payments. In many cases the Commissioner's disallowances of salary are sustained because the corporation lacks evidence to support the deduction.[106]

Salaries Should Be Realistic

The corporation should maintain records which would indicate the amount of time as well as the kind of services rendered by each employee.[107] In many instances, the officer-stockholder may render services to several corporations owning and operating different parcels of realty. In this event, care should be taken that each company compensate the officer realistically in proportion to the value of the services rendered.[108]

Salaries As a Reflection of Earnings

The compensation is more likely to be recognized if it is decided upon before earnings can be predicted, i.e. at the beginning of a taxable year.[109] If the compensation of officers is not determined until after the corporate profits have been calculated and no dividends are declared, the payment may be held to be a distribution of profit in guise of salary.[110] The salaries should remain relatively constant and should not fluctuate drastically in proportion to the profits earned by the corporation.[111]

Since real estate corporations are particularly vulnerable to attack and the disallowances may affect several taxable years due to Treasury Department procedure, it is recommended that planning be applied to the solution of these problems.

Unpaid Interest and Expenses

A corporate taxpayer on the accrual basis may ordinarily deduct accrued interest and expenses payable to employees although they are unpaid at the close of the taxable year and the employees are on the cash basis.[112] An exception to this rule arises when the

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101 Wolder, *Reasonable Compensation*, 24 Taxes 150 (Feb. 1946).

102 See Botany Worsted Mills case cited supra at note 99; A. David Co. v. Grissom, 64 F(2d) 279 (4th Cir. 1933).

103 Winter Realty & Construction Co., 2 TC 38 (1943); Walkup Co., 7 TCM 57 (1948); Kipsborough Realty Corp., 10 TCM 932 (1951).

104 Spring St. Realty Co., 123 F(2d) 146 (3d Cir. 1941); Kipsborough Realty Corp., 10 TCM 932 (1951); Mettler & Sons, 8 TCM 329 (1949).

105 See notes infra in Personal Holding Company section.

106 Amco Investment Co., 4 TCM 307 (1945); Biljac Holding Corp., 5 TCM 857 (1946).

107 Ibid.

108 Winter Realty & Construction Co., 2 TC 38 (1943) (total of salaries from several companies approximated stockholdings); Amco Investment Co., TC Memo. op., 4 TCM 307 (1945) (salary on one company intended to offset inadequate salary of another corporation); Guide Realty Co., 9 TCM 462 (1950) (officers properly compensated by each company for which they worked).

109 Draper & Co., Inc., 5 TC 822 (1945).

110 Werner Machine Co., Inc. v. Manning, 129 F(2d) 105 (3d Cir. 1942), aff'g DC NJ (Jan. 1941); Briles, Inc., 6 TCM 996 (1947).

111 Patton, 6 TCM 482 (1947), aff'd 168 F(2d) 28 (6th Cir. 1948).

112 IRC § 43; Reg 111 § 29.24-7.

employee is a stockholder in a closely held corporation.[113]

In order to close a tax-saving loophole,[114] the Code[115] provides that unpaid interest and expenses are not deductible when all three of the following conditions are present:

1) The unpaid interest and expense has not been paid within the taxable year or within two and one-half months after the close thereof.[116]

a) In order to constitute payment sufficient to avoid disallowance, it must be in cash, or by check,[117] or negotiable note.[118]

2) The amount accrued is properly includible as income in the stockholder-employee's taxable year in which, or with which, the taxable year of the corporation ends, regardless of whether or not the amount is actually paid as stated in (1) above.[119]

a) Although the accrued expense had not been paid within the required period, the deduction is still available to the corporation, providing the interest or expense is "constructively" received by a cash-basis taxpayer.[120]

3) When, at the close of the taxable year of the corporation or at any time within two and one-half months thereafter, the person to whom the payment is to be made owns, directly or indirectly,[121] more than 50% of the stock of the corporation.[122]

Rent-Free Tenants

Rent-free tenants of closely held corporations may be divided into two classes: 1) Non-stockholder-employee who renders services to the corporation, 2) Stockholder-employee, who may render services to the corporation.

Employees Rendering Services

The general rule stated by the regulations[123] provides that "if services are paid for with something other than money, the fair market value of the thing taken in payment is the amount to be included as income . . . . If a person receives as compensation for services rendered a salary and in addition thereto living quarters or meals, the value (thereof) . . . constitutes income subject to tax. If, however, living quarters are furnished to employees for the convenience of the employer, the value thereof need not be computed and added to the compensation otherwise received by the employees."

In 1940, the Bureau interpreted their regulations[124] to explain that the value of living quarters would be excluded

113 IRC § 24(c).

114 The Corporation takes a deduction for unpaid interest and expenses, but the stockholder-employee does not report the income until received. It is possible that the expenses may never be paid or not paid until some year when tax rates are low.

115 IRC § 24(c).

116 IRC § 24(c) (1).

117 Lake, Inc. v. Comm'r, 148 F(2d) 898 (5th Cir. 1945).

118 Anthony P. Miller, Inc. v. Comm'r, 164 F(2d) 268 (3d Cir. 1947); Musselman Hub-Brake Co., 139 F(2d) 65 (6th Cir. 1943).

119 IRC § 24(c) (2).

120 Reg 111 § 29.42–2 provides that income is "constructively" received by a cash-basis employee whenever it is "credited or set apart to the employee without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made, and must be made available to him so that it may be withdrawn at any time, and its receipt brought within his own control and disposition." "Constructive" receipt in following cases: Ohio Battery & Ignition Co., 5 TC 283 (1945); Michael Flynn Mfg. Co., 3 TC 932 (1944); Martindale, Inc. v. Comm'r, 151 F(2d) 190 (3rd Cir. 1945); Ennis Mfg. Co., 3 TCM 937 (1944). Not "constructive" receipt in following cases: Francis Metal Door & Window Corp, 178 F(2d) 405 (2d Cir. 1950). aff'g 7 TCM 755 (1948); Hoyt B. Wooten, 12 TC 659 (1949).

121 IRC § 24(b) and Reg 111 § 29.24–6 contain detailed explanation of "direct and indirect" relationship.

122 IRC § 24(c) (3).

123 Reg 111 § 29.22(a)–3.

124 Mim 5023 (CB 1940–1, 14); O. O. Ellis et al., 6 TC 138 (1946); Carmichael, et al., 7 TCM 278 (1948).

only if the employee were required to accept such quarters to properly perform his duties.

Two years ago, a further clarification by the Bureau[125] stated that despite the employee's occupancy of the quarters for the "convenience of the employer" the value of the residence would be taxable as long as the employer intended thereby to furnish additional compensation to the employee.

In these situations affecting non-stockholder employees, the taxable income of the corporation-employer is not affected, because the value of the living quarters paid constructively in the form of compensation to the employee equals the rental income constructively received by the corporation.

Stockholder Rendering Service

When a controlling stockholder occupies an apartment rent-free and renders services to the corporation, the rules effective for non-stockholder-employees usually apply.[126] If the value of the apartment approximates fair compensation for the services rendered, no difficulty appears in the logic of these conclusions.

Stockholders—Quarters More Valuable Than Services, or No Services Rendered

The difficulties arise when the stockholders either render no services or when the rental value of their living quarters are far above the value of the services rendered to the corporation.

In *Frueauff*,[127] one of the early decisions on this question, an officer and stockholder occupied an apartment rent-free. The fair rental value of this apartment was in excess of $10,000.00. The only duties performed by this officer were to sign the final income tax return of the corporation as well as a few checks during the taxable year. The Tax Court sustained the determination of the Commissioner that the fair value of the apartment constituted taxable income to the officer. The court could not bring itself to call this compensation for services rendered, but stated that it qualified under the general rule of the Revenue Act of 1928, defining gross income as "income received from any source whatever".

A similar problem arises when a stockholder or close member of the immediate family renders no services to the corporation in exchange for rent-free occupancy of the corporation property. In 1945, the following situation arose:[128] A corporation owned four or five small parcels of improved real estate, including a residence occupied rent-free by the mother of the sole stockholder. The mother rendered virtually no services to the corporation. The court held that the mother was not employed by the corporation, therefore she had no taxable income. The corporation merely made a gift of the rental value of the premises to the mother.

Income to Corporation

At the same time that the *Frueauff* case[129] was decided, the Board of Tax Appeals also rendered a decision in the case of *Reynard* v. *Commissioner*.[130] In this case, the Bureau argued that the corporation should be constructively charged for the fair value of the residence occupied rent-free by the sole stockholder. The court rejected this argument stating, without citing authority, "It is error to include the rental value in the gross income of the corporation, apparently on the theory of constructive receipt." Two members dissented from this finding. They believed, on the rationale of *Burnet* v.

125 Mim 6472 (CB 1950–1, 15).
126 Godson, 5 TCM 648 (1946); Reynard Corp., 37 BTA 552 (1934).
127 Frueauff, 30 BTA 449 (1934).
128 Gritmon v. Comm'r, 4 TCM 552 (1945).
129 See note 127, supra.
130 30 BTA 451 (1934).

Wells,[131] that the rental value must be treated as constructively paid to the corporation before it could be considered as compensation for services rendered by the stockholder.

In these cases, the failure of the courts to charge the corporation with rental income for the fair value of the occupied premises is the cause of the unsatisfactory results. In the *Frueauff* case, it would have been logical for the court to increase the income of the corporation by $10,000.00 and permit only a nominal allowance for services rendered by the stockholder. It is probable that the corporation may not have been a party to the action in the *Frueauff* case, but similar justification may not be found in the *Reynard* case where the Commissioner sought to pursue this logical course of action. In those cases where no services at all are rendered, the corporation is entitled to take depreciation[132] and other expenses[133] as a deduction in determining net income, while at the same time making a gift of the fair rental value of its property to the stockholders. It should not be presumed that corporate directors can give away as gratuities valuable rights to the use of corporate property.[134]

What Should Be Done

In these stockholder-rent-free-tenant cases, the corporation should be charged for the fair rental value of the premises; then a deduction should be allowed for the reasonable value of the services rendered. The fair value of the services rendered should be included in the tax return of the stockkholder pursuant to the regulations for ordinary employees. If no services are rendered, no taxable income should be charged to the tenant unless a dividend has actually been declared or unless the intent to make a dividend may be implied.

Personal Holding Companies

Every tax adviser should constantly remember the ever present pitfall of the personal holding company.[135] Although the surtax on personal holding companies was first enacted in 1934 [136] and was revised in its present form in 1938,[137] it is probably the most overlooked provision in the field of corporate taxation.

A national reporter contains a listing of more than fifty cases in which corporations have failed to recognize their status as personal holding companies.[138] In the first six months of 1951, the Tax Court decided four cases in which the required tax return, Form 1120H, was not filed.[139]

Congress found it necessary in 1950 to excuse temporarily certain corporations which had blundered into the personal holding company classification.[140] In sponsoring this legislation, the Senate Committee on Finance stated,[141] "The attention of your committee has been called to examples where, through a set of fortuitous circumstances, corporations . . . unwittingly . . . have become personal holding companies and subject to the penalty tax."

The major reason for this unusual situation is disclosed by an examination

131 289 US 670 (1933).

132 See note 128, supra.

133 E. V. Richards, Jr. v. Comm'r, 111 F(2d) 376 (5th Cir. 1940); Hillman v. Comm'r, 71 F(2d) 688 (3d Cir. 1934).

134 Chandler v. Comm'r, 119 F(2d) 623 (3d Cir. 1940); Noel v. Parrott, 15 F(2d) 669 (4th Cir. 1926).

135 IRC §§ 500–511.

136 Revenue Act of 1934, § 351.

137 Revenue Act of 1938, §§ 401–411.

138 513 CCH Standard Fed. Tax Rep. ¶ 1644.

139 Greenfield, *Personal Holding Company Status,* 29 Taxes 795, October 1951.

140 Revenue Act of 1950, § 223, amending IRC § 502(f).

141 Sen. Rep. No. 2375, 81st Cong., 2d Sess. (1950) p. 65.

of the legislative history of these provisions.[142] The statute was enacted. to assist existing rules which were "designed to discourage the formation or use of a corporation for the purpose of preventing the imposition of surtaxes upon its shareholders through the device of permitting its gains and profits to accumulate instead of being distributed".[143] Congress decided that greater pressure had to be exerted against non-operating companies or so-called "incorporated pocket books".[144] However, in framing this new statute, the Congress created such an inflexible definition that any corporation which fell within the two tests of ownership and income became subject to the penalty surtax independently of the purpose of avoiding surtaxes upon its shareholders.[145]

Penalties

Failure to recognize liability for this tax subjects a corporation to the confiscatory rates of 75% on the first $2,000.00 of undistributed income and 85% on the amount in excess of $2,000.00.[146] It is also possible that the corporation may be subject to the imposition of the 25 per cent delinquency penalty for failure to file a return.[147] If a corporation realizes it is a personal holding company, it may distribute the income to its stockholders in the form of dividends and avoid the surtax penalty.[148] In the event a deficiency in tax is determined with respect to income subject to the personal holding company provisions, the corporation may pay a dividend to offset the deficiency, providing the tax return, Form 1120H, was properly filed.[149]

Requirements

Subject to certain exceptions,[150] every corporation which meets the gross income[151] and the stock ownership[152] requirements is classified as a personal holding company.

The stock ownership requirement is satisfied if not more than five individuals own directly or indirectly[153] more than 50% in value of the outstanding stock of the corporation at some time during the last half of the taxable year.

If 80 per cent or more of the gross income of the corporation consists of "personal holding company income", the income provision is fulfilled. Once a corporation has been classified as a personal holding company, the qualifying percentage is reduced to 70% until a taxable year when the stock ownership requirement is not satisfied or until the expiration of three consecutive tax-

142 Hearings on Revenue Revision, House Ways and Means Committee, 73d Cong., 2d Sess. (Dec. 1933 and Jan. 1934); Hearings before the Joint Committee on Tax Evasion and Avoidance, 75th Cong., 1st Sess. (1937).

143 Revenue Act of 1932, § 104. This section is comparable to IRC § 102.

144 See H. R. Rep. No. 704 and Sen. Rep. No. 558, 73d Cong. 2d Sess. (1934) CB 1939–1 (part 2), p. 562 and p. 598. One example cited by the committees was the case of an individual with $1,000,000 of taxable income from dividends and interest. He would have been subject to a tax of $571,000 if he had received all the income; however, he transferred his stocks and bonds to a corporation which was subject to a tax of only $143,000, thereby saving $428,000 as long as he could prevent the distribution of dividends to himself.

145 Noteman v. Welch, 108 F(2d) 206 (1st Cir. 1940); Smith Enterprise Co., 167 F(2d) 356 (6th Cir. 1948), aff'g 6 TCM 594 (1947); 2 Montgomery's Federal Taxes—Corporations and Partnerships 1950–1, p. 239; Paul, *Personal Holding Companies,* 31st Annual Conference on Taxation (1938), National Tax Association, p. 407.

146 IRC § 500; for computation of tax, see IRC §§ 504 to 506, Reg 111 §§ 29.504–1 to 29.506–12 and Form 1120H.

147 IRC § 291.

148 IRC § 504; Reg 111 § 29.504.

149 IRC § 506.

150 IRC § 501(b). Eight types of corporations are excluded, e.g., (1) Corporations exempt under IRC § 101, (2) A bank as defined in IRC § 104, (3) a life insurance co., (4) a surety co., etc.

151 IRC § 501(a) (1); Reg 111 § 29.501-2.

152 IRC § 501(a) (2); Reg 111 § 29.501-3.

153 IRC § 503; Reg 111 §§ 29.503(a)-1 to -7.

able years in each of which the personal holding company income is less than 70 per cent.[154]

Section 502 of the Internal Revenue Code defines personal holding company income as that portion of the gross income which consists, among other types of income, of the following:

"f) Amounts received as compensation for use of corporation property by shareholders.

"g) Rents, unless constituting 50 per cent or more of gross income."

When the personal holding company provisions were first introduced into the tax statutes,[155] no reference was included to income now classified in Section 502(f). Our present regulations define this income as ". . . . . . . compensation (however designated and from whomever received) for the use of, or the right to use, property of the corporation in any case in which, at any time during the taxable year, 25 per cent or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for an individual entitled to the use of the property . . ."[156] This classification was the result of the public hearings of 1937.[157] At that time it was revealed that corporations were using these stockholder-corporation transactions as a device to reduce their investment income below the 80 per cent test by adjusting the amounts of compensation paid by the stockholders. Furthermore, taxpayers had incorporated their yachts, city residences, or country homes and paid enough rent[158] to exclude the corporation from the personal holding company classification.[159]

Thus, while it is apparent that Section 502(f) was directed primarily towards the so-called "incorporated pocket-books", it has been applied to other types of situations.[160] The Senate Finance Committee recognized those situations where closely held corporations have become personal holding companies by renting most of their assets for use in the operation of a business by individuals owning the stock of the corporation.[161] The Revenue Act of 1950[162] provided relief by amending Section 502(f) so that rents received during the taxable years ending after December 31, 1945 and before January 1, 1950 would be excluded from personal holding company income, provided the lessee used the property of the taxpayer "in the operation of a bona fide commercial, industrial, or mining enterprise". Despite this temporary relief, it is likely that the future will find

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154 IRC § 501(a) (1).

155 Revenue Act of 1934, § 351.

156 Reg 111, § 29.502-1(9).

157 Hearings before the Joint Committee on Tax Evasion and Avoidance, 75th Cong., 1st Sess. (1937).

158 Rent was not classified as personal holding income at the time. See note 167 infra.

159 H. R. Rep. No. 1546, 75th Cong., 1st Sess. (1937) (CB 1939-1 (part 2) (Committee hearings) p. 707).

160 Operating business divided between corporation operating and/or owning real estate and stockholders operating business as individuals or partners: Hatfried, Inc. v. Comm'r, 162 F(2d) 628 (3rd Cir. 1947), aff'g and rev'g (on penalty) 5 TCM 77 (1946) (Corporation constructed Miami, Fla., hotel and leased it to sole stockholder); Bro-Jeff Theatres, Inc. v. Comm'r, 4 TCM 1147 (1945), appeal dism. (nolle prosse) October 21, 1946 (Corporation purchased and constructed theatres; rented them to partners, each of whom owned more than 25 per cent of stock in corporation); Walnut St. Co. v. Glenn, 83 FSupp 945 (DC Ky 1948) (Corporation purchased storehouse building and leased to partnership; partners owned 90 per cent of stock). Where operating business divided between two corporations, although controlled by same stockholder, not held to be personal holding company income on the basis of the separate legal entities, Minnesota Mortuaries, Inc., 4 TC 280 (1944) (Separation of real estate and funeral business) (Same stockholders), Plaza Realty Co., 2 TCM 801 (1943) (Taxpayer corporation rented theatre to another corporation owned by same stockholders).

161 Sen. Rep. No. 2375, 81st Cong. 2d Sess. p. 65.

162 § 223.

more companies overlooking the consequences of this section.

As far as rental income is concerned, presently classified under Section 502(g), it is interesting to note that the original draft by the Ways and Means Committee included all rents in personal holding company income.[163] However, the Senate Finance Committee excluded "rents" from the 80 per cent definition and the law was so enacted.[164] The committee of the Upper House explained that a great part of real estate business is done by small family corporations which are more in the nature of operating companies than mere holding companies.[165]

In 1937, Congress realized as the result of the hearings before the Joint Committee[166] that the entire exemption of rents permitted certain personal holding companies which were not bona fide operating companies to escape their proper classification by simply having enough rental income to constitute 21 per cent of total gross income.[167] Therefore the rules were amended so that rents which did not constitute 50 per cent of the gross income of the corporation were to be classified as personal holding company income. "Rents" were to be defined in their broadest sense, including such items as charter fees, and was not to be limited to rentals for the use of real property; however, compensation covered by subsection (f) above was to be excluded.[168]

The final amendment was made to this section in 1938.[169] It added to the term "rents" interest on debts owed to the corporation, to the extent such debts represent the price for which real estate held primarily for sale to customers in the ordinary course of business was sold or exchanged by the corporation. The Ways and Means Committee[170] explained that "this change would help those bona fide real estate operating companies which might find themselves subject to the tax in years in which by reason of an inactive market for the sale of real estate, the greater part of their income is derived from interest on second mortgages of property previously sold by them and rent from property leased pending its sale and these rents do not constitute 50 per cent of the gross income". Where interest is received on a purchase money mortgage, it is not includible within the above definition as rents, where the sales are so infrequent that the property is held for investment rather than primarily for sale to customers in the ordinary course of business.[171]

Every Closely Held Corporation Is a Potential Personal Holding Company

The realization that every closely held corporation is a potential personal holding company should cause all tax advisers annually to consider carefully the questions pertaining to personal holding companies on the ordinary corporation income tax return, Form 1120. Minute changes in ownership or income may unexpectedly subject corporations to this surtax penalty. The observation by the Senate Committee of the nature of real estate in operating through closely held corporations should be sufficient warning to all those engaged in assisting these taxpayers.[172]

Court decisions indicate that experienced tax lawyers and accountants, as well as revenue agents, have overlooked

163 H. R. Rep. No. 704, 73d Cong. 2d Sess. (1934) (CB 1939-1 (part 2) p. 563).
164 Revenue Act of 1934, § 351.
165 Sen. Rep. No. 558, 73d Cong. 2d Sess. (1934) (CB 1939-1 (part 2) p. 596).
166 See note 157 supra.
167 H. R. Rep. No. 1546, 75th Cong. 1st Sess. (1937) (CB 1939-1 (part 2) p. 708).
168 Ibid.
169 Revenue Act of 1938, § 403(g) (now IRC § 502(g)).
170 H. R. Rep. No. 1860, 75th Cong., 3d Sess. (1938) (CB 1939-1 (part 2) p. 765).
171 Smith Enterprise Co. v. Comm'r, 167 F(2d) 356 (6th Cir. 1948).
172 See note 165 supra.

the applicability of these provisions on many occasions.[173] While it is true that the 25 per cent delinquency penalty is usually not imposed on a corporation, where its failure to file a personal holding company return could be traced to a qualified tax adviser in full possession of the pertinent facts,[174] remembering the provisions of these sections of the law will avoid the necessity of confession.[175]

Involuntary Conversions

Although the Treasury Department has permitted the principle of non-recognition of gains on involuntary conversions since 1918,[176] and Congress since 1921,[177] the tax consequences of this section[178] of the Internal Revenue Code have recently assumed a great degree of significance. Public and quasi-public agencies have been taking over substantial amounts of property in connection with highway construction[179] and Federal government defense projects.[180] Furthermore, on October 31, 1951 the President signed a new law[181] which amended Section 112(f) and extended the benefits of non-recognition of gain to taxpayers[182] by liberalizing existing requirements.[183]

Prior to the recent changes in the law, the following general principles governed the postponement of tax due to gain on involuntary conversions:[184]

(a) If property—as a result of its complete or partial destruction, theft, seizure, or condemnation—was involuntarily converted into property similar or related in service or use to the property converted, no gain would be recognized.

(b) If under the same circumstances, the property was converted into money, again no gain would be recognized, provided the funds obtained were forthwith expended for the replacement of "similar" property,[185] or held in a replacement fund pursuant to the regulations.[186] If all of the proceeds of the conversion could not be traced to the purchase of "similar" property, the gain, if any, would be recognized to the extent of the unexpended funds.[187]

The new statute[188] divides Section 112(f) of the Internal Revenue Code into three paragraphs:

1. The first division[189] of this section refers to conversions into similar property and is identical with paragraph (a) referred to above.

2. The next paragraph[190] covers conversions into money where the disposition (defined as destruction, theft, seizure, requisition or condemnation of

173 See note 138 supra.

174 Hatfried v. Comm'r, 162 F(2d) 628 (3d Cir. 1947); Girard Investment Co. v. Comm'r, 122 F(2d) 843 (3rd Cir. 1941); Haywood Lumber & Mining Co. v. Comm'r, 178 F(2d) 769 (2d Cir. 1950). Contra: Fides v. Comm'r, 137 F(2d) 731 (4th Cir. 1943).

175 See note 139 supra.

176 Reg 33 (Rev.), Article 94 as amended by TD 2706, 20 Treas. Dec. 348 (1918).

177 Revenue Act of 1921, § 214(a) (12) individuals, and § 234(a) (14) corporations.

178 IRC § 112(f).

179 Wikel, *Profit Without Taxation*, 28 Taxes 1080 (November 1950); Lipton, *Involuntary Conversions*, 29 Taxes 529 (July 1951).

180 Report of House Committee on Ways and Means on H.R. 3590, 82d Congress, October 1951.

181 Public Law 251, 82d Congress.

182 IRC § 112(f) (3).

183 Reg 111 § 29.112(f)-1 and -2.

184 Ibid.

185 Replacement could also be effected by acquiring control of a corporation (80 per cent ownership of stock) owning such property.

186 Reg 111 § 29.112(f)-2.

187 Id at -1.

188 See note 181 supra.

189 IRC § 112(f) (1).

190 Id at (2).

the converted property, or the sale or exchange of such property under threat or imminence of requisition or condemnation) occurred prior to January 1, 1951, regardless of when the proceeds are received. In this instance, the existing rules summarized in (b) above remain unchanged.

The literal interpretations of the law by the Treasury Department in its regulations,[191] which were approved by the Courts,[192] necessitated the recent revision in order to prevent otherwise qualified taxpayers from being deprived of its benefits.

This section was originally designed to prevent an inequitable incidence of taxation.[193] Since its provisions furnish relief,[194] they should be liberally construed to effectuate their purpose of postponing the taxation of gain from involuntary conversion.[195]

The rule of liberal construction was seldom applied to the "tracing"[196] provision of the regulations, so that where the taxpayer purchased replacement property prior to the receipt of the award, it did not qualify for relief because none of the proceeds were available to pay for the replacement.[197]

Similarly, relief was denied or limited where the award was used, although for a temporary period, to discharge an indebtedness on the converted property.[198] Although the cost or replacement equaled the amount of the proceeds to the extent that the funds were used to discharge a lien, gain was recognized; provided, of course, the proceeds exceeded the basis of the converted property.[199]

3. The last paragraph of the revised Section 112(f) eliminates the "tracing" requirement and its consequences mentioned above.[200] This new rule applies where the property is involuntarily converted into money or into property not similar or related in use or service to the converted property and the disposition occurred after December 31, 1950.

Requirements of New Statute

Subject to the following limitation, in order to effect non-recognition of the gain, the taxpayer need only purchase "similar" property or control of a corporation owning such property:

a) The replacement must be purchased within the period of time beginning with the date of disposition of the converted property or the date of the beginning of the threat or imminence of condemnation, whichever is the earlier, and ending one year after

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[191] Reg 111 § 29.112(f)-1 "The taxpayer must trace the proceeds of the award into the payments for the property so purchased. It is not necessary that the proceeds be earmarked, but the taxpayer must be able to prove that the same were actually reinvested." . . . "If, in a condemnation proceeding, the Government retains out of the award sufficient funds to satisfy liens . . . and mortgages against the property and itself pays the same, the amount so retained shall not be deducted from the gross award in determining the net award."

[192] See cases cited infra notes 196 to 198 inclusive.

[193] Washington Market Co., 25 BTA 576, 584 (1932).

[194] International Boiler Works Co., 3 BTA 283, 291 (1926).

[195] Davis Regulator Co., 36 BTA 437, 442 (1937); Paul Haberland, 25 BTA 1370, 1378 (1932); August Buckhardt, 32 BTA 1272, 1277 (1935).

[196] See note 191 supra. Frischkorn Development Co., 30 BTA 8 (1934), aff'd 88 F(2d) 1009 (6th Cir. 1937).

[197] Anticipatory Replacement Cases: Louis Bandes v. Commissioner, 69 F(2d) 812 (2d Cir. 1934) aff'g 28 BTA 99 (1933), cert. den. 293 US 568 (1934); Vim Securities Corp., 130 F(2d) 106 (2d Cir. 1942), aff'g 43 BTA 759 (1941), cert. den. 317 US 686 (1942); Twinboro Corp. v. Commissioner, 149 F(2d) 574 (2d Cir. 1945), aff'g TC memo op. 1943. Contra: Washington Railway & Electric Co., 40 BTA 1249 (1940), A 1940-1 CB 5, but see I. T. 3827 (1946-2 CB 57) limiting acquiescence to facts involved. Wilmore Steamship Co., Inc. v. Commissioner, 78 F(2d) 667 (2d Cir. 1935), rev'g 30 BTA 866.

[198] Kennebec Box and Lumber Co., Inc. v. Comm'r, 168 F(2d) 646 (1st Cir. 1948), aff'g 6 TCM 544 (1947); Ovider Realty Co., 10 TCM 433 (1951).

[199] Ibid.

[200] See notes 196 through 198 supra.

the close of the first taxable year in which any part of the gain upon the conversion is realized or at the close of such later date as the Secretary may designate upon the application of the taxpayer.[201]

It is likely that pursuant to this provision a replacement fund may be authorized by the Secretary, conditioned upon the posting of a bond by the taxpayer for payment of the proper tax in the event the replacement is never made or is made at a cost lower than the amount realized upon the conversion.[202]

This proviso eliminates the requirement for replacement "forthwith" which had plagued the Commissioner and the courts.[203] If a replacement fund was not established, it was necessary for the replacement to be made forthwith.[204] Instead of an actual time limit similar to that established under the new amendment, the taxpayer had to prove that he acted as quickly as possible under the circumstances.[205]

If Replacement Uncertain

Where it is uncertain when replacement can be made, it is advisable, for dispositions occurring prior to 1951, to request permission to establish a replacement fund as soon as possible, pursuant to the requirements of the regulations.[206] The funds received should be carefully identified (preferably segregated in a separate cash account or in marketable securities) because the "tracing" rules apply, although this is not necessary if they are not used for any other purpose but replacement or provisional investment. It is advisable that book entries be made to indicate the status of the fund.[207]

b) If the replacement property was acquired prior to the disposition of the converted property, it must be held by the taxpayer on the date of disposition to be considered as a replacement.[208]

c) The property shall be considered as having been purchased as a replacement only if its unadjusted basis would be its cost to the taxpayer,[209] except for the "basis" provisions relating to involuntary conversion.[210] This provision[211] excludes property received by gift, inheritance, tax-free exchanges, etc.[212]

Benefits Are Elective

The benefits of Section 112(f)(3) are elective and the Secretary will prescribe in his regulations the time and the manner in which the taxpayer may

201 IRC § 112(f) (3) (B).

202 Report of House Ways and Means Committee on H. R. 3590, 82d Congress, October, 1951.

203 Lipton, *Involuntary Conversions*, 29 Taxes 529 (July 1951). See cases cited infra, note 205.

204 This test is still applicable to disposition occurring prior to January 1, 1951.

205 Acceptable as "forthwith": Buckhardt, 32 BTA 1272 (1935) (proceeds received March 1931—Replacement made July 1933; taxpayer sought farms with suitable soil continually during period and replacement made as soon as possible); Herder v. Helvering, 106 F(2d) 153 (CA of DC 1939), cert. den. 308 US 617 (1939), (funds received March 1934—reinvested May 1935; taxpayer made continual efforts to find replacement); Haberland, 25 BTA 1370 (1932), (proceeds received October 1921—replacement completed January 1923, under the circumstances of building a new organization, the replacement was completed as rapidly as possible). Unacceptable as "forthwith": Caldbeck, 36 BTA 452 (1937), (proceeds realized in 1932—replacement in 1936, delay due to poor business conditions); Chickasha Cotton Oil Co., 18 BTA 1144 (1930), (unexplained delay of 16 months too long).

206 Reg 111 § 29.112(f)-2.

207 Brown, *The Replacement Fund in Involuntary Conversions*, 29 Taxes 137 (February 1951).

208 IRC § 112(f) (3) (A) (i).

209 IRC § 113(a).

210 IRC § 113(a) (9).

211 IRC § 112(f) (3) (A) (ii).

212 See note 180, supra.

exercise such election.[213] If the taxpayer decides to request the benefits of this section, the gain shall be recognized only to the extent that the amount realized on the conversion exceeds the cost of the replacement property, whether the amount received is realized in one or more taxable years.[214]

It is important to realize that the rules existing prior to the recent changes may be effective for many years, since awards for property involuntarily converted prior to 1951 may be received indefinitely in the future. Furthermore, the new law retains the provisions requiring that replacement property be "similar or related in service or use to the property converted".[215] The replacement need not be an exact duplication of the converted property.[216]

This entire subject is of great interest to real estate operators and the forthcoming regulations should be carefully examined by affected taxpayers with a view to postponement of tax on gains due to inflated values during a period of very high tax rates. Although the rules have been clarified for those conversions occurring after 1950, care must be taken to conform to all the requirements of the statute.

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213 IRC § 112(f) (3) (A).

214 Ibid.

215 § 112(f) (1) (2) and (3) as amended.

216 "Similar" property: Cotton Concentration Co., 4 BTA 121 (1926), (converted property: two buildings; replacement: one building, same area, same use); Davis Regulator Co., 36 BTA 437 (1937), (converted property: leased factory; replacement: purchased factory, both interests in real estate); House Ways & Means Committee Report, see note 180, supra. (Converted property: farm land used for growing crops; replacement: farm land for growing fruit or raising livestock.)

Not "similar" property: Reg 111 § 29.112(f)-1.

Converted property	*Replacement*
1. Unimproved realty	1. Improved realty
2. Real property	2. Reduction of indebtedness of prior acquired realty
3. Requisitioned tug	3. Barges

Winter Realty & Construction Co. v. Comm'r, 149 F(2d) 567 (2nd Cir. 1945), cert. den. 326 US 754 (1945). (Converted property: condemned realty; replacement: mortgages on realty.)

An Illustration of the Use of Statistical Probabilities in Auditing

By Lester Ageloff, C.P.A.

This paper illustrates the use of statistical techniques in a typical auditing problem-situation. The author states that, as a result, the chance of undectected error is materially lessened while, at the same time, a reduction in auditing costs is effected.

In many cases, the use of statistical techniques to evaluate the efficiency of test-checks in auditing is purely a matter of application of a few simple principles, and the mathematics involved is no more difficult than elementary algebra. All other more complicated calculations can usually be circumvented by the use of published tables. In the following illustration, only these elementary concepts are employed:

1) Let P = the probability of the occurrence of an event, expressed as a decimal.

Then (1 — P) = the probability of the event not occurring.

Since P + (1 — P) = 1, the probability of an event occurring, plus the probability of the event not occurring, when added together, must equal unity.

Lester Ageloff, C.P.A. was employed for several years in public accounting in New York City, and is at the present time with G., H. and E. Freydberg, Inc., in the capacity of Assistant Comptroller.

He received his B.B.A. in Accountancy and his M.B.A. in Statistics from The City College of New York. At the present time he is a doctoral candidate at the Graduate School of Business Administration at New York University, preparing a dissertation on the applications of statistics in auditing.

He is a member of Beta Gamma Sigma and the American Statistical Association.

2) The probability of the occurrence of an event which may happen in two or more alternative ways is the sum of the probabilities of the various alternatives.

3) The probability of the simultaneous occurrence of two or more independant events is the product of their respective probabilities.

The reader will no doubt recall these rules of probabilities from his college algebra days. We will also use the concept of the Poisson distribution to explain certain low-probability characteristics of the data, but the use of this formula should present no difficulty to the auditor, since it is available for use in published tables.

We shall study the problem of determining the efficiency of test-checking the addition of columnar journals. The method outlined is perfectly general, and may be used in test-checking any page, no matter how many lines or columns it may have. Let us assume that we are checking a voucher register for correctness of addition. Let us further assume that this material had been audited the previous year, and from last year's worksheets we have gotten the information that there were 20 errors in footing discovered among 4,000 columns checked, so that the average error was .005, or one-half of one percent. Similarly, last year the errors in extensions were .001 of the total audited. How much can we rely on test-checking this year?

The solution to this problem is as follows:

Let N_l = the number of lines or entries on the page.

N_c = the number of columns on the page.

P_l = the probability of an error in the extension of an item, based upon previous experience (refers to mathematical correctness only, not to correctness in the sense of putting the item in the proper column).

P_c = the probability of an error in the addition of a column, based on past experience.

Then the expectation of error on any particular page (referring only to the types of errors discussed above) can be expressed as:[1]

$$E(E) = N_l P_l + N_c P_c$$

(Total expectation of error equals the number of lines times the probability that one line is incorrect, plus the number of columns times the probability that one column is incorrect.)

To cite a numerical example: suppose that the voucher register we have mentioned has twenty columns, and there are fifty lines to a page. Then, in mathematical symbols:

$$N_l = 50 \qquad P_l = .001$$

$$N_c = 20 \qquad P_c = .005$$

Then the total expectation of error on an unaudited page will be:

$$E(E) = (50 \times .001) + (20 \times .005)$$
$$= .15$$

Every column that is audited will reduce the total expectation of error by .005, and every line that is audited will reduce the total expectation of error by .001, since the values of N_l and N_c refer to the amounts of *unaudited* items.

Suppose that the columnar totals are footed across and the page is found to be in balance. Then, the only errors possible would be compensating errors. The occurrence of compensating errors depends on the probability of more than one error occurring on a page. Let us examine the number of ways that more than one error can occur on a page:

(a) There can be two or more footing errors, while the extensions are correct;

(b) There can be two or more errors in extension, while the footings are correct;

(c) There can be any combination of footing and extending errors occurring simultaneously.

The possible combinations of errors are represented in the following table, with the lettered cells corresponding to the three classifications mentioned above:

		Number of footing errors		
		0	1	2 or more
Number of errors in extension	0	no errors	one error	(a) two or more errors
	1	one error	(c) two errors	(c) three or more errors
	2	(b) two or more errors	(c) three or more errors	(c) four or more errors

[1] *Expectation* is a mathematical concept which, in laymen's terms, can best be described as "weighted probability." The distinction between the two concepts is this: as the number of items increases, the probability of error remains the same, but the expected number of errors increases. Or in other words, as the number of items increases, we will not get a larger proportion of errors (probability), but we will get a larger number of errors (expectation). The probability of an error will never exceed unity, while the expected number of errors may often be more than one.

The technical nature of this distinction can be seen in the illustrative case given above: it is correct to say that we may expect 15/100 of an error per page, rather than to say that the probability of error is 15/100. The result is the same, since there will tend to be 15 errors for each 100 pages, no matter which concept be used.

Of the nine possible combinations, six will result in the occurrence of two or more errors on a page. In order to find the expectation of compensating error, we must find the probability of these six combinations. The probability of occurrence of any combination is the product of the probabilities of its two components.

The probability of none, one, or two errors of footing or extension occurring on a page can be closely approximated by using the Poisson distribution,

$P(x) = \frac{e^{-m}m^x}{x!}$, where $P(x)$ is the probability of getting x number of errors,

$$e = 2.718 \ldots$$
$$m = NP$$
$$x! = \text{factorial } x \text{, or}$$
$$x(x-1)(x-2) \ldots (3)(2)(1).$$

This function can be calculated, or published tables of the Poisson distribution may be referred to, giving P (x) for various values of NP. Actually, we are only concerned with the first two terms of the series, which represent P(O) and P (1), the probabilities of none, and one, error occurring. From these, the probability of two or more errors can be calculated.

In the Poisson series,

$$P(0) = e^{-m}$$

and $\quad P(1) = e^{-m}(m)$

The values of e^{-m} are also available in published tables which are more extensive than the published Poisson tables.

Since the page is in balance, the probability of compensating error coincides with the probability of the combinations of two or more errors.

Referring to the diagram, the probability of compensating error may be expressed as the sum of the following probabilities:

(a) Probability of two or more errors in footing at the same time that there are no errors in extension, or:

$$[1 - (P_{oc} + P_{1c})] \; [P_{ol}]$$

Plus (b) Probability of two or more errors in extensions at the same time that there are no footing errors, or:

$$[1 - (P_{ol} + P_{1l})] \; [P_{oc}]$$

Plus (c) Probability of one or more errors in each occurring at the same time, or:

$$[1 - P_{oc}] \; [1 - P_{ol}]$$

The total probability of compensating error is, therefore:

$$P(E_c) = [1 - (P_{oc} + P_{1c})]$$
$$[P_{ol}] + [1 - (P_{ol} + P_{1l})]$$
$$[P_{oc}] + [1 - P_{oc}] \; [1 - P_{ol}]^*$$

Using the numerical data given, the solution of this equation requires the probabilities of zero and one error in footing and extending.

In footing, $N_c = 20$, and $P_c = .005$;

then, $m = NP = (20)(.005) = .1$

From a table of the Poisson distribution,

$P_{oc} =$	$.9048374 =$	Probability of no errors in footing on a page
$P_{1c} =$	$.0904837 =$	Probability of exactly one error in footing on a page
$1-(P_{oc} + P_{1c}) =$	$.0046789 =$	Probability of getting more than one error in footing on a page
	$1.0000000 =$	Total of the above probabilities.

* Several alternate formulas are possible. For example, $P(Ec) = 1 - [(Poc\,Pol) + (Poc\,P1l) + (P1c\,Pol)]$ would be easier to compute than the formula given above, which is employed because it better illustrates the basic theory.

In extensions, $N_1 = 50$, and $P_1 = .001$;

then, $m = NP = (50)(.001) = .05$.

Using a table of e^{-m}

$P_{o1} = e^{-m} = e^{-.05} = .9512 =$ probability of no error in extension on a page

$P_{11} = (e^{-m})(m) = (.9512)(.05) = .04756 =$ probability of one error in extension per page

$1-(P_{o1} + P_{11}) = .00124 =$ the probability of two or more errors in extension per page.

The total probabilities equal unity in this case also, as they must, since .00124 is arrived at by subtracting the sum of the first two terms from one.

Thus, the probability of a compensating error is found to be:

$$P(E_c) = (.0046789)(.9512) + (.00124)(.9048374) + (.0951626)(.0488)$$
$$= (.00445) + (.00112) + (.00464)$$
$$= .01021, \text{ or approximately } 1\%.$$

As was true in the case of the total error, the chance of occurrence of an undetected compensating error can be reduced by a partial audit of a number of columns or lines. This reduces the value of m, on which the Poisson distribution is based, by reducing the value of N in the expression NP=m.

It should be noted that the method outlined above can only be used to analyze the occurrence of *chance* errors; naturally, if the totals were "forced" by the bookkeeper, the use of a sampling method will only lull the auditor into a false sense of security. Therefore, it would be salutary for the auditor to check the footings of a few columns on each page, as well as to determine whether or not the page is in balance. Any systematic "forcing" of totals would tend to be uncovered by this additional check. Indeed, the limitations of this method are the same for all sampling methods; the existence of a good system of internal control is a prerequisite, so that the incentive for committing intentional errors is minimized. If previous experience has shown a suspiciously large amount of offsetting errors, indicating the possibility of forced totals, or if the test-footings on each page uncover the same situation, this method should be abandoned in favor of a 100% audit.[2]

In any event, if the test-check is used, the columns selected for audit should include those representing balance-sheet items (such as the accounts payable column in the voucher register, and the cash and receivables columns in the cash receipts book), since fraudulent errors are most likely to occur in those particular columns. Control account columns will provide the additional safeguards afforded by the independent periodic proof of subsidiary ledger balances against the controlling account.

If the conditions of internal control are such that the use of a sampling method is not unwarranted, the increase in precision arising from the use of the proposed method instead of the traditional method of sampling would recommend the use of the proposed method as the safer and more economical of the two. In the proposed method, namely, checking to see that every page is in balance, and test-footing the balance sheet or control columns only, the average risk of error is only the probability of compensating error (in the

[2] There are statistical tests available which can aid the auditor in deciding whether or not the occurrence of a specified number of offsetting errors could have been a chance occurrence. See technical note at the end of this paper.

numerical case cited, 1%). In the traditional method, namely completely auditing the records for a number of selected months, the probability of undetected error in the audited months is nil, but the expectation of error on an unaudited page was found to be (in the case cited) .15. Since in the one case we are dealing with a probability, and in the other case, with an expectation, the two cannot be compared until both are stated in the same terms. We will do so by comparing the total expected number of undetected errors under both methods of auditing.

For the purpose of this numerical example, we must make two further assumptions:

(a) the record being audited consists of 3,000 pages;

(b) three months would be selected for a complete audit under the traditional method, consisting of ¼ the total number of pages, or 750 pages.

Suppose that the traditional method of auditing were used; the results could be expressed as follows:

Description	Number of Pages	Expectation of Undetected Error Per page	Expectation of Undetected Error Total
Audited completely	750	none	-0-
Unaudited	2250	.15	337.5
Total	3000		337.5

Now suppose that the proposed method of test-checking were used; the results would be as follows:

Description	Number of Pages	Probability of Undetected Error per Page	Expected Number of Undetected Errors
Test-checked	3000	.01021	30.63

With the particular numerical data given, the use of the proposed method would effect a reduction in the expected number of undetected errors from 337 to 31, for a decrease of 91%. This will be accomplished with a saving in the amount of labor required, as follows:

Method of Auditing	Number of Pages Checked	Footings Checked per Page	Extensions Checked per Page*	Total Number of Calculations to be Performed
Traditional	750	20	1	15,750
Proposed	3000	1	1	6,000
Net Saving				9,750 (62%)

(* under either method, crossfooting of totals would be the only extensions checked)

It should be noted that the number of undetected errors when the proposed method is used will be slightly smaller than that shown above, since one column on each page is to be footed, but the original calculations of undetected error presupposed no footings.

Conclusions

A departure from the traditional methods of auditing basic data is suggested, based on the calculation of probabilities as outlined in this study. The chance of undetected error would be lessened materially, with a reduction of auditing costs at the same time.

While the illustrative computations in this article presuppose a knowledge of the amount of errors in the material, based on past audits, such information is not a prerequisite for using the method outlined. The information is needed for the calculation of the extent of decrease in probable error which is gained by using the proposed method, but even if this calculation be not made, the proposed method can be used with the assurance that it increases protec-

tion in all cases. The only condition for the use of the proposed method is the necessary condition for *any* sampling method to be used: that enough be known about the conditions of internal control so that the risk of fraudulent error is at a minimum.

It should also be noted that the actual risk of a compensating error will in most cases be less than that calculated. What we are calculating is the *maximum* chance of offsetting error, this being the probability of two or more errors occurring on a page. However, only a part of all the sets of two or more errors on one page will be mutually offsetting, so that the page will remain in balance. The rest of the cases of multiple error will be detected when the page is tested for balance. But, since we have considered all possible combinations of more than one error as a risk of compensating error, we have overstated the chances of being wrong. Thus the proposed method gives even better assurance than is indicated by the calculations. What the calculations show is the worst possible percent of incorrect pages that could be expected to occur, if the incidence of errors is due to chance.

* * *

Technical Note: A Statistical Test for the Determination of the Probability of Occurrence of an Observed Deviation from a Theoretically-Determined Value

In order to help the accountant decide whether or not an observed percent of compensating errors is suspiciously large, the following statistical test may be used:

In the numerical example cited above, P(Ec), or the maximum probability of a compensating error, was found to be .01021. Suppose 200 pages were audited, and 4 errors of the offsetting type were discovered, for an average of 4/200, or .02. Could this have been due to chance, or is there evidence of "forced" totals?

We use the test, $t = \dfrac{P - p}{s_p}$, where: P = expected percent

p = observed percent

and $s_p = \sqrt{\dfrac{P \times (100 - P)}{n}}$

n = number of observations (pages audited)

$$\text{In this case, } t = \frac{2 - 1.021}{.9899} = \frac{.979}{.9899} = .99$$

This number, .99, is then compared with a published table of Fisher's t-test (*Example:* page 875 of Croxton and Cowden, *Applied General Statistics*). This table gives the probability of getting various values of t, representing deviations from expected values, at different numbers of observations. From this table we find that the probability of getting a value of .99 for 200 observations is approximately .3. Thus, in three out of ten cases, such a deviation will occur as a result of chance. In such a case, the auditor is apt to be sceptical, but not convinced one way or the other, and will probably resort to more testing.

TERMS OF THE POISSON DISTRIBUTION AT PROBABILITIES LIKELY TO BE ENCOUNTERED IN AUDITING

Average probability of error m	Proportion of pages containing no error $P_0 = e^{-m}$	Proportion of pages containing exactly one error $P_1 = me^{-m}$	Proportion of pages containing one or more errors $1 - P_0$	Proportion of pages containing two or more errors $1 - [P_0 + P_1]$
.001	.99000	.00099900	.00010	.0000001
.005	.99502	.00497510	.00498	.0000049
.01	.99005	.0099005	.00995	.0000495
.02	.98022	.0196044	.01978	.0001756
.03	.97044	.0291132	.02956	.0004468
.04	.96079	.0384316	.03921	.0007784
.05	.95124	.0475620	.04876	.0011980
.06	.94177	.0565062	.05823	.0017238
.07	.93239	.0652673	.06761	.0023427
.08	.92313	.0738504	.07687	.0030196
.09	.91392	.0822528	.08608	.0038272
.1	.90484	.090484	.09516	.004676
.2	.81875	.163750	.18125	.017500
.3	.74082	.222246	.25918	.036934
.4	.67032	.268128	.32968	.061552
.5	.60653	.303255	.39347	.090215
.6	.54884	.329304	.45116	.121856
.7	.49658	.347606	.50342	.155814
.8	.44933	.359464	.55067	.191206
.9	.40657	.365913	.59343	.227517
1.0	.36788	.36788	.63212	.26424

Intermediate values may be obtained by linear interpolation, or by using the relationship: $\log (e^{-m}) = (-m)(\log e)$, where $\log_{10} e = 0.434294482$. The values in the above table are correct within the limitations of a seven-place logarithm table.

Charles Ezra Sprague—Public Accountant

By The Committee on History

This article points up three important but less widely known aspects of the later career of this early leader of our profession: (1) his relationship to the earliest effort to provide specialized formal education for the public practice of accounting; (2) his preparation of the first CPA law; and (3) his service upon the first State Board of CPA Examiners.

The 67-page biography of Colonel Sprague by Helen Scott Mann, which New York University published in 1931, is very interesting and in some respects quite satisfactory. The author told of his parentage and boyhood; of his four years at Union College where he was graduated (A.B.) in 1860 when he was 18 years of age, receiving an A.M. in 1862 and his Ph.D. in 1896, and becoming a Life Trustee in 1906; of his enlistment in the Union Army in May, 1862, being wounded at Gettysburg, and discharged a Colonel in March, 1864. The story continues, after his wound had healed sufficiently, with his teaching in the military academies in Yonkers, Peekskill and Poughkeepsie. His biographer recited incidents of his marriage and family life, their travel, his interest in the artificial languages, Volapuk and Esperanto, and his love of music particularly that of Sousa's and other bands. Though necessarily brief, this recital seems to be complete as to these phases of his life, except that it does not mention his "teaching in what is now Greenwich Union Academy, remaining there a year and a half" which Colonel Sprague included in a sketch for a Union College publication in 1907. And of less importance, it did not mention his adoption of simplified spelling of which he was an advocate and which he used in some of his writings.

> This is the eighth in a series of articles on the History of Accounting in the State of New York. It was prepared by the Society's Committee on History.

The biographer very properly told of his 41 years in the Union Dime Savings Bank, and gave more space to his service in the School of Commerce, Accounts and Finance of New York University, and to his authorship, but told only incidentally and largely by quotation, of his participation in accountancy as a profession.

Without minimizing in any degree the importance of his activities in the fields covered in the Mann biography it seems that his experience in bookkeeping and accounting was a major factor in preparing him for the more spectacular services he rendered during his last ten or fifteen years.

In the chapter on his authorship the biography stated:

> "In addition to writing articles for business magazines, such as *Business* and *The Office,* he took an active part in the publication of two, acting as associate editor of *The Bookkeeper* and *The Journal of Accountancy.*" (Chapter 5, page 57)

While no confirmation has been found of such association with the *Journal,* he was connected with *The Bookkeeper* and the story of that relation introduces the reader to his activities in accountancy.

The publication of *The Bookkeeper* was begun July 20, 1880, and in its issue of August 31, 1880, page 64, it said of itself:

> "The First and only Publication of its character in the world."

As published for the groups he ad-

dressed that was true. *The Accountant,* London, was first published in October, 1874, but it was addressed to public accountants.

To the first issue of *The Bookkeeper* Sprague contributed the first of four installments on the "Algebra of Accounts," and in the fourth issue, August 31, he began a series on "Bank Bookkeeping" which he carried through 25 installments to December 31, 1881. Before that series was completed, the editor, Selden R. Hopkins, announced in the issue of August 2, 1881, that Charles E. Sprague

> "will henceforth share the duties and responsibilities of the editorial department of *The Bookkeeper.*"

That relationship continued through June 19, 1883, when the name and format were changed and, instead of a bi-weekly as *The Bookkeeper* had been during 3 years, it was published monthly as *American Counting Room* from July, 1883.

Apparently these magazines like others in limited fields had financial difficulties. As of January 1, 1884, the periodical, which up to that time had been the property of Hopkins, was incorporated as the Counting Room Company, Limited, with Sprague as President, George S. Parker as Vice President, and Hopkins as Secretary-Treasurer. But in March following, Hopkins withdrew and as a result no issues were published during April and May, but Sprague brought out an issue for April-June 1884. His editorial explanation of the delay indicated that the publication would be continued, but no later issue has been found. Since it appears that he was the largest stockholder, probably because of loans to Hopkins prior to 1884, it is not unreasonable to suppose that he, as a banker during the preceding decade, realized that the publication could not be made to pay its way.

But his connections with these publications during 3 years as contributor and editor were not Sprague's only relation with them. He was also an advertiser. *The Bookkeeper* in October 26, 1880, page 128, with other notices carried the following:

> "Charles E. Sprague
> Accountant
> Address, by mail, Union Dime Savings Institution
> Broadway and 32nd St., New York, N. Y."

At that time, after 7 years as a clerk in the Savings Bank, he had become its Secretary. The public practice for which he offered his services, was probably a side vocation but almost surely one in which he was greatly interested. His professional card was continued throughout. And the February 27, 1883, issue (page 77) said:

> "The editors of The Bookkeeper will undertake the audit, adjustment and examination of accounts of corporations, public officers, manufacturers, merchants, etc., in any part of the United States. They may be consulted on questions of accountancy, and will advise in the organization and the opening and closing of books of account."

Of course this may have been the beginning of Sprague's practice as a public accountant, but since Hopkins had been practicing since 1868, it seems probable that the association of Hopkins and Sprague in editorial work and public practice was based upon a longer experience of Sprague's. He was listed as a public accountant in the New York Directory of 1885.

Quoting from the introduction by John R. Loomis in the fifth edition of "The Philosophy of Accounts," the biography, on page 63 in referring to the Institute of Accounts and American Association of Public Accountants, said that Sprague was

> "among the earliest to assume membership in these organizations."

That was incorrect as to the Association, in which his membership dated from the entrance of the New York State Society of C.P.A's. in 1905.

However it was correct as to the Institute, which he joined fairly soon after its organization in 1882. Fre-

quently he lectured at its meetings and he was its President on December 15, 1886, when the Institute had Edwin Guthrie of Manchester as its guest. He joined the New York State Society of C.P.A's. in May, 1897.

As his Army service had prepared him for his teaching in the three military academies; as those years with his earlier teaching in the Greenwich Union Academy had equipped him for the art of instruction; and as his clerical work in the bank had provided the knowledge which he put into his many articles in *The Bookkeeper;* so these experiences, coupled with that from his public practice, his editorial work, and his membership in the Institute of Accounts, prepared him for other services barely mentioned or not at all in the Mann biography.

The first of these and the one of which the least is known was his relationship to the earliest effort in the world to provide specialized formal education for the public practice of accounting. Early in 1892, the American Association of Public Accountants sent to the Regents of the University of the State of New York, a petition for a charter for a College of Accounts. A hearing thereon was held in Albany on June 8, 1892, when those who met with the Regents Committee included 14 officers and members of the Association, Melvil Dewey, Secretary to the Regents (in many ways corresponding to the present Commissioner of Education) and a long-time friend of Dewey, Charles E. Sprague. There are no records of his participation in the meeting—he seems to have been only an observer—but it also seems that he may have told his friend Dewey that the purpose was important, but the proposal then made was too ambitious. If so it is highly probable that Dewey passed the advice on to the Regents.

The next instance was in the matter of CPA legislation and as to that we have Sprague's own statement. *Business* for July, 1896, page 320, printed Col. Spragues' letter of July 10, thus:

> "The above is a copy of a bill prepared by me and introduced in the Legislature in January (actually March) 1895, including Section 4 which was withdrawn in committee. I prepared the bill as a member of a committee of the Institute of Accounts. This copy has been in my possession ever since January 24, 1895 until today. C. E. Sprague."

As is common knowledge the bill was defeated in the Senate in 1895, but was passed almost unanimously in 1896. The success in 1896 seems to have been due to the Association's Committee and especially Frank Broaker. But the scope and wording of the bill were Sprague's, no doubt with advice from Dewey, but Sprague must have the credit for having a good advisor.

The third instance, that of his service on the State Board of Examiners was briefly mentioned in the biography and in his autobiographical sketch prepared in 1907. There are records as to the reasons for the selection of the other two members appointed in 1896, but not as to the selection of Colonel Sprague. It seems quite possible that he may have been suggested by a formal resolution of the Institute of Accounts. That is not known, however, because no trace of the Institute's records has been found. But even if the Institute did or did not suggest him for appointment by the Regents it is almost certain that the Regent's Secretary Melvil Dewey, who had opinions as to the administration of the CPA Law which he knew were contrary to the hopes and expectations of most public accountants, wanted on the Board of Examiners one whom he had known for long and on whose judgment he felt he could rely.

To Certified Public Accountants, while recognizing the value of his authorship and teaching, it seems that his preparation of the first CPA Law and his service upon the first State Board of Examiners were the most important services of Charles Ezra Sprague.

New York State Tax Forum

Conducted by Benjamin Harrow, C.P.A.

Refund of Income Tax—Interest

A bill passed by the 1952 Legislature specifically provides that refunds of income tax "shall be without interest"[1] Hitherto the Tax Commission paid interest at the rate of 4% on refunds, even though there was no provision for such payment. In a case involving the franchise tax[2] the Court held that it could not compel the Commission to do anything beyond its statutory authority, such as the payment of interest upon a refund.

Non-Resident Employees

A non-resident employed in New York is subject to tax only on the income he earns in New York. If the non-resident is employed by the Treasury Department at an office of the Internal Revenue Agent located in New York State, he is earning his salary in New York and is subject to the New York State Income Tax on his salary. Suppose the employee is on disability leave and actually has not performed any services in New York during most of the taxable year. Would the entire salary be subject to the New York tax? In our opinion it would. His status is still that of an employee earning income in New York. The extent to which he is actually performing services would not control taxability.

Suppose the work of the federal employee carries him into other states for short periods. Would the compensation for these periods be exempt from the New York tax? In our opinion it would not. The employee is attached to a New York office and works out of that office even though some of the work is performed in other states.

Benjamin Harrow, C.P.A., has been a member of our Society since 1928. He is a Professor of Law at St. John's University.

Mr. Harrow has been a member of the American Institute of Accountants since 1922 and is a member of the New York Bar. He is now serving on the Society's Committee on Federal Taxation, and is past Chairman of its Committee on State Taxation. He is also a member of the Institute's Committee on Federal Taxation and its Council.

Mr. Harrow is engaged in practice as a certified public accountant and attorney in his own office in New York City.

Estate Tax

The federal estate tax return is due within fifteen months from the date of death. The New York estate tax return is due within eighteen months. Under the federal law, failure to make and file a return within the prescribed time results in a penalty of 5% of the tax if the failure is for not more than 30 days. The penalty may be avoided if the failure is due to a reasonable cause and not to willful neglect.

Under Section 811 (j) of the Internal Revenue Code the tax may be computed according to the optional method of valuation as of the date one year after death. The election to use the optional valuation is effective only if the return is filed within fifteen months. (Section 81.11 Reg. 105). In a recent case[3] both provisions were in

[1] L. 1952, c. 571 effective April 7, 1952.
[2] *Burrell* v. *Lynch*, (1949) 274 A.D. 1083.
[3] *Estate of Fred B. Frish* v. *Commissioner*, T. C. Memo, Docket No. 26483, January 28, 1952.

issue because the estate tax return was received in the Collector's office one day after the fifteen months. The decedent died on April 21, 1946, and the return was mailed on July 21, 1947, before 3 P.M. It was received by the Collector on July 22, 1947. According to the Regulations (Section 81.63), "the return should be posted in ample time to reach the collector's office, under ordinary handling of the mails, on or before the date on which the return is required to be filed."

In what seems to be a harsh decision the Court upholds the Commissioner's contention that the privilege of using the optional valuation date was lost because of late filing and the 5% penalty was upheld. Said the Court, "mere mailing does not qualify as 'filing'." To use the optional valuation the taxpayer must comply with the statutory requirements. On the issue of the 5% penalty, the Court said that it could be avoided only if the late filing was due to reasonable cause and not to willful neglect. The filing of the return was turned over to the attorney, but how long before the due date was not established. The Court said that the attorney had only a limited experience in tax matters, but that he had consulted the Regulations before preparing and mailing the return. It was also noted that there was no explanation as to why the mailing was put off until the due date. The Court surmised that the attorney might have thought that if the return was mailed on the due date, it would be treated as filed on time. There was no showing that the failure to file within the prescribed time was due to a reasonable cause and the 5% penalty was added.

The State Tax Commission has been more lenient in matters of filing. A technical breach of the law may be corrected by an affidavit submitted to the Commission and a request that the return be considered as having been filed on the proper date *nunc pro tunc*.

Trust Income—Constructive Receipt

Under a trust set up for the benefit of four children income was payable to the children quarterly. The trustees had the power to add to the principal any portion of the income which, in their judgment, was not required for the comfortable support and maintenance of each child. For thirteen years all the income was paid to the children. The trustees and the beneficiaries filed income tax returns on a calendar-year and cash basis. Some of the payments were made during the year but a substantial balance was usually distributed after the close of the year (February 18) when the trustees filed annual probate accounts.

For the year 1941, one of the beneficiaries received $2,075.74 from the trustees. Trust income available to the beneficiary for 1941 amounted to $6,486.11. The difference of $4,410.37 was paid to the beneficiary on February 18, 1942. The issue before the Court[4] was whether the beneficiary was taxable on $6,486.11 or $2,075.74. The Court held that the beneficiary was taxable on the amount currently distributable to her under the doctrine of constructive receipt.

The action of the trustees for thirteen years indicated the establishment of a definite pattern to give the beneficiaries all of the income and therefore none of the income came within the provision that income which may be accumulated is taxable to the fiduciary. The Court held as far-fetched the argument that within the calendar year the trustees could not ascertain exactly the amount of income for that year that could be distributed. While the probate accounts were not rendered on a calendar-year basis, the trustees could just as reasonably have ascertained the income on December 31 as on February 18 of the following year. The bulk of the yearly income was available at all times and the beneficiaries had the right to receive it currently.

[4] *Channing* v. *Hassett*, U.S.D.C., District of Mass., February 4, 1952.

Under the New York State Income Tax law, the income of a trust which is to be distributed to beneficiaries periodically, whether or not at stated intervals, is taxable to the beneficiaries. This is similar to the Federal provisions.

New York Estate Tax—Jointly Held Property

A husband and wife owned a bond and mortgages as joint tenants. This was transferred to an *inter vivos* trust together with other assests. The trust income was payable to the wife for life and the grantors reserved the right to alter or amend the trust agreement in whole or in part. After the death of the husband, the Tax Commission included the entire value of the bond and mortgage in the taxable estate under Section 249-r, subd. 4 and subd. 5. The latter provides for the inclusion of the value of property held by a decedent and another as joint tenants, except such part as may be shown to have belonged to the other person.

The Court held[5] that there was no proof that the decedent's wife had contributed any amount to the acquisition of the bond and mortgage. The transfer in trust of the jointly held property by joint tenants did not remove the requirement of the statute. It was no different from a trust created by an individual.

Installment Payments of State Income Taxes

Several important changes have been made in the provisions governing payment of State income taxes. The general rule still is that the tax may be paid in full at the time of the filing or in four equal installments. The first installment is due on or before the 15th day of the fourth month following the close of the fiscal year and the remaining installments must be paid on or before the 15th day of the seventh, eleventh and fourteenth months following the close of the fiscal year. For calendar-year taxpayers these dates would be April 15, July 15, November 15 and February 15. If the tax is not over $10.00 it must be paid in full with the filing of the return. If the tax is over $10.00 but less than $40.00, the installments need not be equal but only the final payment may be under $10.00.

Change of Residence

In the case of a change of status from resident to non-resident, or vice-versa, two returns are required. For the resident portion of the year, Form 201 must be used and for the non-resident portion, Form 202. However these returns are due only if the taxpayer's combined income from all sources during the resident period and from New York sources during the non-resident period equal or exceed the usual requirements for determining liability to file.

The return for the period prior to the change must be on the accrual basis regardless of the taxpayer's previous method of reporting, and the personal excemption and credit for dependents apportioned between the two returns on the basis of the number of months covered by each return. The tax on the two returns for the one year may not be less than the tax on a single return because of the change of residence. Deductions must be itemized; the optional deduction may not be used on either return.

[5] *Matter of Edward John Connor, dec'd.* Surrogate's Court, Westchester County, N.Y.L.J., March 14, 1952, page 1047.

Notes on the New York State Unemployment Insurance Law

Conducted by SAMUEL S. RESS

Late Filing Penalty Not Discharged by Bankruptcy; Interest Thereon Discharged

A bankrupt debtor applied to the New York State Supreme Court for the discharge and cancellation of a judgment filed against it by the Industrial Commissioner consisting of a $500.00 penalty together with $81.97 in interest, levied pursuant to Section 575, Subdivision 2, of the Unemployment Insurance Law.

Prior to the bankruptcy proceedings the employer corporation failed to file its payroll reports for the first quarter of 1949 on time. Despite the further demand by the Industrial Commissioner that the report be filed within 20 days, the employer failed to comply with the demand on time and a $500.00 penalty was imposed. The employer then protested the penalty and demanded a hearing, but the Unemployment Insurance Referee sustained the imposition of the penalty, in a decision rendered on March 16th, 1950. In August, 1950, the employer corporation field a petition for reorganization under Chapter X of the Bankruptcy Act, which petition was subsequently amended to provide for relief under Chapter XI of that statute.

SAMUEL S. RESS has been an Associate Member of our Society since 1936, and is also a member of the Bar. He has specialized in the payroll tax field since the inception of this type of legislation in 1936.

Dr. Ress is a member of the Society's Committees on Clothing Manufacturing Accounting, on Labor and Management, and on State Taxation.

The State of New York filed a $6,009.64 claim for Unemployment Insurance contributions which was allowed and paid in full by order of the Bankruptcy Court on January 11th, 1951. The State filed no claim for the penalty, despite the order of the United States District Court requiring the State of New York, among others, to file any claims for taxes or non-tax debts of the debtor and that upon failure to file claims within the time fixed no such claims could thereafter be asserted against the Trustee or the debtor corporation.

The reorganization was terminated on January 22nd, 1951. On January 3rd, 1952, the Industrial Commissioner filed a warrant as a judgment against the discharged, reorganized, employer corporation, pursuant to Section 573, Subdivision 2, of the Unemployment Insurance Law. In a decision handed down on May 9th, 1952, by New York State Supreme Court Justice Roberts in Monroe County, the court denied the application of the judgment debtor for the discharge and cancellation of the $500 penalty. However, the court did allow the cancellation of the $81.97 which represented interest upon the penalty. (*The People of the State of New York,* Plaintiff, against *J. G. Menihan Corp.,* Defendant;—Misc.—, 5/9/52.)

The Court stated in its decision:

"Section 150 of the Debtor and Creditor Law authorizes the discharge of a judgment representing a debt from which the judgment debtor has been discharged in bankruptcy. A discharge in bankruptcy releases a bankrupt only from his provable

debts . . . the order of the district Court related only to the filing of claims provable and allowable under the Bankruptcy Act as the authority of the Court to make such order would necessarily be limited to such claims.

"A debt owing to the State as a penalty or forfeiture is not a provable or an allowable claim in bankruptcy except for the pecuniary loss sustained, with costs occasioned thereby, and such interest as may have accrued thereon. . . . The penalty imposed against the defendant corporation was not a provable or an allowable claim or dischargeable in bankruptcy, and hence, the judgment so far as it represents such penalty is not subject to cancellation and discharge. . . (citing cases). . .

". . . interest upon the penalty . . . represented an allowable claim in bankruptcy, . . . defendant is entitled to a discharge . . . to the extent of such interest item. . . ."

Principal Stockholder and Week of Employment

A principal stockholder, employed by a corporation liable for contributions, acquires "weeks of employment" for the purposes of Section 527 (d) of the Unemployment Insurance Law, although his compensation for such employment does not constitute "remuneration" under the exclusions of Section 517, Subdivision 2. It was held that remuneration was not an element in determining a week of employment (Appeal Board Case No. 31,071-52, decided 4/25/52). In the case at bar, the Local Office held that claimant, a fur operator, was ineligible for benefits because he did not have 20 weeks of employment as required by Section 527 (d) of the Unemployment Insurance Law. The claimant appealed from this determination. In February, 1950, the claimant and another furrier organized a corporation in which the claimant obtained a 50 percent stock interest and became its president. The balance of the stock in the corporation was held by another stockholder who became the Secretary-Treasurer. The claimant served the corporation, which became subject to the Unemployment Insurance Law, both as an officer and as a fur operator. His earnings were reported by the corporate employer for unemployment insurance purposes until April 1, 1951. He continued to render services thereafter until November 30, 1951. On December 13, 1951, the corporation ceased operations completely. The claimant filed his application for unemployment insurance benefits on November 30, 1951. The claimant's earnings not having been reported for the period subsequent to April 1, 1951, apparently made it appear that he had only 18 weeks of employment for which contributions were paid to the State. The Appeal Board decided that while the provisions of Chapter 792 of the Laws of 1951 excluded from remuneration

". . .(d) Compensation paid by a corporation to an employee who is a principal stockholder in that corporation. Principal stockholder means one who owns 25 percentum or more of the capital stock of the corporation; (Section 517.2 d). . . ."

"Concededly claimant's compensation subsequent to April 1, 1951, was not taxable as contributions under the law and claimant is not entitled to be credited with such as earnings in covered employment. However, that is not decisive of the issue herein. Section 527 defines a valid original claim as follows: . . . Valid original claim is a claim filed by a claimant who meets the following qualifications: (a) is able to work, and available for work; (b) is not subject to any disqualification or suspension under this article; (c) his previously established benefit year, if any, has expired; (d) has had at least 20 weeks of employment in the 52 week period preceding the filing of such claim; (e) has earned remuneration averaging at least 15 dollars per week in at least 20 weeks of employment in such 52 week period. . . ."

Section 526 defines a week of employment as a week in which a claimant did some work in employment for an employer liable for contributions under this article. The law requires that some work be performed for an employer liable for contributions under the law. ". . . The corporate employer is liable for contributions . . . claimant rendered services after April 1, 1951, and therefore comes squarely within the definition of a week of employment as provided for under Section 526. . . ."

Office and Staff Management

A forum for the exchange of views and information on all aspects of the administration of an accounting practice.

Conducted by MAX BLOCK, C.P.A.

Avoidance of Duplicate Typing of Tax Return Schedules

Federal income, and state income and franchise tax returns, require a good deal of identical data. For example, there is duplication of data between the federal income tax return and the New York income and franchise tax returns with respect to these schedules:

Cost of goods sold
Cost of operations (where there is no inventory)
Officers' salaries (with provision for variation)
Taxes (with slight variation which can be provided for)
Contributions (with provision for variation in amount deductible)
Other deductions
Balance sheet
Surplus reconciliation

If schedules are prepared as attachments to the return, then, by making enough copies at one typing, the requirements for both returns can be taken care of. This will save considerable time otherwise involved in duplicate typing.

There has been some doubt and question as to what will be acceptable to the tax departments as attachments. This matter has now been clarified by the Commissioner of Internal Revenue as to federal income tax return forms 1120, 1065, and 1040. As a result of action taken by our Society's Committee on Federal Taxation, through its Chairman, Benjamin Grund, a letter was received from the Commissioner specifying the policy with respect to attachments. This letter is reproduced below.

Efforts are being made to get a similar expression of policy, as favorable as possible, from the New York State Tax Commission.

MAX BLOCK, C.P.A. (N. Y., Pa.) is a Director of the New York State Society of Certified Public Accountants and has been the chairman of the Society's Committee on Administration of Accountants' Practice. He is a member of the firm of Anchin, Block & Anchin.

U. S. TREASURY DEPARTMENT
WASHINGTON 25

Office of
COMMISSIONER OF INTERNAL REVENUE
Address reply to
COMMISSIONER OF INTERNAL REVENUE
And refer to
TT:RP:PR
LB

May 23, 1952.

The New York State Society of
Certified Public Accountants
677 Fifth Avenue
New York 22, New York

Attention: Mr. Benjamin Grund
Chairman, Committee on
Federal Taxation

Gentlemen:

Reference is made to your letter dated April 11, 1952, relative to the preparation of Federal income tax returns, particularly with respect to the manner of furnishing the information and supporting data called for in the various pages and schedules of the different return forms.

You state that in the past many of your members have been following the practice of attaching profit and loss

statements and supporting schedules, as well as balance sheets and reconciliation of book and taxable income, and analysis of surplus, in lieu of filling in on the return form, the corresponding information called for on pages 1 and 4 of the corporation and partnership returns (Forms 1120 and 1065), and in separate Schedule C of the individual return (Form 1040). Where such statements are attached, they are generally carbon copies of similar statements included in the accounting reports submitted to the taxpayers.

You state that this method saves a good deal of time in the preparation of returns, with other attendant benefits, and request advice as to whether the practice is satisfactory to the Bureau and may be continued.

With respect to the submission of separate profit and loss statements, you are advised that the attachment of such statements, in any form, in lieu of the completion of page 1 of the corporation and partnership returns, has a number of objectionable features which makes such a practice very undesirable from the standpoint of the Bureau. The submission of substitute profit and loss statements in lieu of the separate Schedule C (Form 1040), in the case of individual returns, is equally undesirable, especially in view of the present special design and dual-purpose feature of the official form. It is therefore urged that the indicated previous practices in these respects, be discontinued.

With respect to the presentation of the supporting data called for in the various other schedules of the return forms, you are advised that the Bureau has no particular objection to the submission of such information in separately attached schedules, rather than in the spaces provided in the form itself, provided that the attached schedules are complete in all details and are in the same form as the schedules in the return.

Very truly yours,
/s/ E. I. McLarney
Deputy Commissioner

Office and Staff Managers Luncheon Meetings

Within one year since its organization the luncheon discussion group has grown to a size which is close to taxing its present space capacity. This rapid development is evident recognition of the importance and benefits to be derived from the analysis and discussion of the problems of administration of an accounting practice directly by those dealing with them daily.

At the meeting held on May 29th, the following were the major subjects discussed:

1. *Use of ring binders for work papers.*
   This discussion will be continued at the next meeting when, it is expected, a member will display a binder actually used.

2. *Use of plastic bindings for reports to have them open flat.*
   In this instance, too, the discussion will be continued at the next meeting when actual samples will be submitted by a member.

3. *Furnishing business cards to staff members.*
   The discussion disclosed that some firms provide business cards to supervisors and top seniors. These are firm cards with the man's name imprinted in the lower left-hand corner. Other firms have firm cards available to men for use as the individual need arises. Still other firms do not supply business cards at all and apparently have not recognized a need therefor.

4. *Methods for advising the New York State Tax Department of changes in taxable income made by the Internal Revenue Bureau.*
   Various control and follow-up measures are employed. Some firms assume the responsibility

for notifying the State Tax Department directly, whereas others advise the client as to what must be done and furnish the required data. However, the measures taken to insure that such changes are reported, regardless of who reports same, are quite individualistic and some are not fool-proof. This subject requires more study and will receive further attention.

5. *Insurance coverage for loss of valuable papers and replacement cost of valuable papers.*

   It was brought out that valuable papers insurance was an expensive matter but that the premium for the cost of reconstructing papers (such as the cost of sending a man to an office to obtain data) was not as costly. There apparently is little use of such insurance among the firms represented at the meeting.

The discussion group meets on the last Tuesday of each month at 12 Noon at the Hotel Lexington, Lexington Avenue and 48th Street, New York City. All interested are welcome.

Federal Tax Examinations Today

Federal income tax examinations have assumed a new significance since the reorganization of the Internal Revenue Bureau. It is even possible that the full effects have not yet been observed. Examiners ask for more substantiation of deductions than heretofore, make more intensive analyses, and are generally more technical. This, in turn, makes the accountant's job more difficult and increases the time devoted to examinations. This situation is not momentary and may even expand.

Accountants must recognize this problem not alone from the operating cost angle but that of client relations where disallowances and assessments will run higher than previously.

These problems should be met frankly and in a business-like manner. It may be desirable to advise all taxpayer-clients, by special communication, as to the changed examination conditions and the consequences. This should prepare them for the more intensive examinations and the probable demands for more and better supporting data.

Such a bulletin should also point out the greater care that may be necessary in the future in the keeping of records of travel, entertainment, and other expenses of a vulnerable nature. This advance information should help make the accountant's position less difficult and may facilitate fee adjustments that may be necessitated by abnormal increases in tax examination time and complexities.

Accountants' Papers Subject to Examination By Tax Bureau Though Year Is Outlawed

A Federal District Court recently handed down a decision (*Rose Schulman, et al., Ex'rs.,* v. *Dunlap,* D.C. N. Y. 5/3/52) which draws an important distinction between the Bureau's rights against a taxpayer and its rights against the taxpayer's accountants.

It has been long recognized that the Bureau cannot make an examination, or reexamination of a taxpayer's records after the statute of limitations has expired, except upon a definite claim of fraud, not a mere possibility. A less rigid requirement, however, is applicable to accountants, according to the subject decision.

In the case cited, the Commissioner had received information which indicated possible fraudulent or criminal activity in an outlawed year. He sought to examine the accountants' records but was resisted on the same grounds available to the taxpayer. However, the Court held that accountants are not subject to the same rules which free taxpayers from unreasonable examin-

(Continued on page 442)

The Excess Profits Tax Exchange

Conducted by David Zack, C.P.A.

This department is a clearing house for questions, problems, comments and rulings regarding Excess Profits Taxes. We are especially interested in special and informal Bureau rulings on Excess Profits Taxes. All items of general interest will be published herein and full credit will be given all contributors unless they request otherwise. All inquiries and contributions should be addressed to:

Editor, The Excess Profits Tax Exchange
The New York Certified Public Accountant
677 Fifth Avenue
New York 22, New York

Ceiling Rates for Acquiring Corporations

The February, 1952, issue of this column pointed out an apparent anomaly in the law which seemed to permit acquiring corporations under Part II to qualify for the new corporation ceiling rates under Section 430(e) without tacking on the experience of the component corporation. We then pointed out that this statutory construction seemed clearly contrary to Congressional intent, and we are now indebted to Alexander E. Slater, C. P. A., for an informal Bureau ruling supporting the basic legislative pattern. The ruling, secured by G. Frieder, C. P. A., states that the Bureau of Internal Revenue will require the addition of the life of the component to the life of the acquiring corporation for the purposes of Section 430(e) as well as for Part II purposes. It must be remembered, of course, that this ruling is merely an indication of the Bureau's interpretation of the law, that it does not have the force and effect of law and that it is fully subject to judicial review. The subject is sufficiently important to warrant reproduction of the ruling in full:

"Reference is made to your request for a ruling as to whether the X corporation is a new corporation as defined in Section 430(e) for its fiscal year ended April 30, 1951, and, for the purpose of that section, was in its fourth taxable year.

"The facts submitted are essentially as follows:

"The X corporation was organized on January 21, 1948, and commenced business on February 1, 1948, at which time it acquired all of the assets of a partnership (which was in business prior to July 1, 1945) in a Part II transaction under Section 112(b) (5). It has filed all of its returns on the basis of a fiscal year ended April 30, and the tax return for its fiscal year ended April 30, 1951, will be for its fourth corporate taxable year.

"Provisions of the Internal Revenue Code pertinent to the above-described transaction are included under the heading of 'Part II—Excess Profits Credits Based On Income in Connection with Certain Changes.' Significant code references affecting the instant case are in substance as follows:

"(1) The term 'acquiring corporation' means a corporation which has acquired

David Zack, C.P.A. and member of the Bar, is a member of our Society and of its Committee on Federal Taxation. He is Chairman of the Committee on Municipal and Local Taxation.

Mr. Zack is a Lecturer on Taxation at The City College (N. Y.) School of Business and Civic Administration and at the New York University Institute on Federal Taxation.

Mr. Zack has written on tax matters for various publications. He is a partner in the firm of David Berdon & Co., Certified Public Accountants.

substantially all the properties of a partnership in an exchange to which Section 112(b)(5) is applicable. (Section 461(a)(1)(d)).

"(2) The term 'component corporation' means, in the case of a transaction specified in Section 461 (a)(1)(D), the partnership whose properties were acquired. (Section 461(b)(5)).

"(3) In the case of a taxpayer which is an acquiring corporation, the determination of its average base period net income is prescribed in Section 462(a) to (h) and in the case of a partnership which is a component corporation by virtue of Section 461(b)(5) the computations required by Part II are made, under rules and regulations prescribed by the Secretary, as if such partnership had been a corporation. (Section 462(k)).

"The prescribed regulations state that, 'Every corporation which is a party to a Part II transaction, whether as an acquiring corporation or as a component corporation, must compute its excess profits credit based on income under the provisions of Part II.***' (Section 40.461-1(c)).

"Further particulars as to the intended treatment of the base period income of an acquiring corporation are provided in the discussion by the committee on Ways and Means under Part II as follows:

'This part, *** is directed essentially at the problem of providing for a proper determination of the average base period net income of a taxpayer which is a continuing corporation in a reorganization involving the transfer to it of properties from other corporations in whose hands the properties had a base period experience. Essentially Part II provides that, *** the income experience of the properties in the base period in the hands of the transferor corporations shall be considered as the income experience of the transferee for those years.'

"The above reference to the transferor corporation, according to Section 461(b) means corporations or partnerships, the properties of which are transferred in a transaction described in connection with an acquiring corporation. It is further stated 'Since all Part II transactions involve a sufficient continuity of interest to justify treating the acquiring corporation as standing in the place of its predecessors, such transactions must satisfy the requirements of Section 112 with respect to such transactions in order that the transferee corporation may be treated as an acquiring corporation.' (I. R. B., C. B. 1951-1, Pages 231-232.)

"In the instant case the transferee corporation acquired the assets of a partnership in a Section 112(b)(5) transaction and the provisions of Part II are applicable thereto.

"Inasmuch as the query concerns the application of Section 430(e), relating to the maximum tax for new corporations, it may be stated that references by the House and Senate Committees to corporations which qualify as new corporations are consistent in the specific exclusion from its provisions, the type of transaction referred to above. In the instance of the House Committee on Ways and Means concerning 'alternate basis for new corporations,' the new corporation is described in part as, '*** A new corporation which commenced business at any time after the beginning of the base period *(and which was not an acquiring corporation* whose treatment is discussed with reference to Part II) ***.' (I. R. B., C. B. 1951-1, Page 202.) (*Underscoring* supplied.)

"More relevant to the instant case is the following extract from the Senate Finance Committee Report describing the general purposes of the provisions of Section 430(e):

" 'These special ceiling rates available to new corporations in their period of development are not to be available to new corporations created as the result of***a tax free reorganization. ***Your committee believes that such corporations do not truly represent "new business".

"Based on the foregoing, it is concluded that the X corporation cannot be considered a new corporation as defined in Section 430(e) for its fiscal year ended April 30, 1951.

"Formal regulations in regard to Section 430(e) of the Code have not as yet been issued. In the absence of such regulations, this ruling can only be tentative and subject to any change which may be required to conform with any subsequent published regulations."

Office and Staff Management

(Continued from page 440)

ations, and that their records must be submitted for review.

If this rule prevails, accountants may expect increased calls from the Internal Revenue Bureau for old files. The decision is in conflict with others and further adjudication is probable. This case should be watched.

OFFICIAL DECISIONS *and* RELEASES

SEVENTEENTH ANNUAL REPORT
of the
SECURITIES AND EXCHANGE COMMISSION
(Fiscal Year Ended June 30, 1951)

Section Dealing With the Activities of the Commission in Accounting and Auditing

The detailed provisions of the several Acts administered by the Commission contain wide recognition of the fact that much of the data necessary to investment or other financial decisions consists of financial statements and related material and that, accordingly, accountants and accounting perform a vital role in achieving the statutory objectives of full and fair disclosure, the prevention of fraud or inequitable and unfair practices, and control and regulation. Thus, for example, the Securities Act provides not only for inclusion in the registration statement and prospectus of data as to financial structure and other similar material but also provides for the furnishing of balance sheets and profit and loss statements.[1] Similar provisions as to registration statements and periodic reports are contained in the Securities Exchange Act,[2] the Holding Company Act[3] and the Investment Company Act.[4] In order to ensure that in the furnishing of such financial information the statutory objectives as to investors and public protection are met, the Acts vest the Commission with broad authority in matters of accounting and financial statement presentation. The Securities Act, for example, authorizes the Commission to define accounting terms, to prescribe, among other matters, "the form or forms in which required information shall be set forth, the items or details to be shown in the balance sheet and earning statement, and the methods to be followed in the preparation of accounts . . ."[5] Substantially equivalent authority is contained in the Securities Exchange Act,[6] and more comprehensive powers are embodied in the Holding Company Act[7] and the Investment Company Act.[8]

The Securities Act provides that the required financial statements shall be certified by "an independent public or certified accountant."[9] The other three statutes above mentioned provide that the Commission may require, and its rules do require, that such statements be accoumpanied by a certificate of independent public accountants.[10] The value of certification has for many years been conceded but the requirement as to independence, long recognized by some individual accounts, was for the first time authoritatively and explicitly stated by its introduction into the statutes. Out of this initial provision in the Securities Act and the resulting rules established by the Commission[11] there have grown concepts that have materially strengthened the protection afforded investors by eliminating certain unhealthy accountant-client relationships which theretofore were quite common.

Although the statutes administered by the Commission give it wide rule-making power, accounting, based as it is largely upon convention and existing financial and business concepts, is of such a nature that the Commission has not yet found it necessary or desirable in most areas to establish extensive accounting rules and regulations dealing with accounting problems. The Commission has prescribed uniform systems of accounts for certain public utility holding companies and for public utility mutual and subsidiary service companies. It has adopted rules under the Securities Exchange Act governing ac-

[1] Secs. 7, 10 (Schedule A, par. 25, 26).
[2] Secs. 12 (b) (1), 13 (a), 15 (d).
[3] Secs. 5 (b) (2), 14.
[4] Secs. 8 (b), 30.
[5] Sec. 19 (a).
[6] Sec. 13 (b).
[7] Secs. 14, 15.
[8] Secs. 30, 31.
[9] Sec. 10 (a) (1) (Schedule A, par. 25, 26).
[10] Securities Exchange Act, sec. 13 (a) (2); Investment Company Act, sec. 30 (e); Holding Company Act, sec. 14.
[11] See, for example, rule 2-01, Regulation S-X.

counting and auditing of exchange members, brokers, and dealers. In the wider area dealing with industrial, commercial, and investment companies under the Securities Act, Securities Exchange Act, and Investment Company Act the form and content of most financial statements are governed by the Commission's Regulation S-X.

The rules and regulations thus established do not prescribe the accounting to be followed except in certain basic respects. In the large area not covered by such rules the Commission's principal reliance for the protection of investors is on the determination and application of accounting standards which are recognized as sound and which have come to have general acceptance. This policy of the Commission is expressed in Accounting Series release No. 4 (1938) (one of the series of such releases, of which there are now seventy-two, inaugurated in 1937 for the purpose of contributing to the development of uniform standards and practice in major accounting questions).

One of the inevitable results of this policy has been constant contact and cooperation between the Commission and accountants, both individually and through such groups as the American Institute of Accountants, the American Accounting Association, the Controllers Institute of America, the National Association of Railroad and Utilities Commissioners and others, and other regulatory agencies. The importance of, and necessity for, this cooperation is emphasized by the great influence and responsibility inherent in the Commission's authority over the several thousand financial statements filed every year with it by most of the important commercial and industrial companies in the United States.

The accounting staff of the Commission is organized to handle the many day-to-day accounting problems that arise in the course of its work and to provide central responsibility for aiding the Commission in matters of accounting policy. The chief accountant has general supervision with respect to accounting and auditing policy and its application. He is assisted directly by a staff of trained accountants, and, in addition, by assistant chief accounts assigned to and responsible for the examination of financial data and other operating work in the Division of Corporation Finance, Division of Public Utilities, and Division of Trading and Exchanges.

Examination of Financial Statements

The majority of the accounting problems with which the Commission is concerned arise from examination of financial statements or other data required to be filed with the Commission. In general, deficiencies revealed by examination are called to the attention of the registrant by letter. Those letters of comment and the correspondence or conferences that follow have proved to be a most convenient aid in effecting correcitons and improvements in financial reporting. Few matters involve prolonged discussion or dispute in spite of the tremendous volume of financial data reviewed each year by the Commission; and it is only in rare instances that formal procedures are necessary in order to procure disclosure.

Many problems arise as a result of inquiry by representatives of registrants, their accountants or counsel in advance of the actual filing of the material involved. Advance discussion of this kind is encouraged and experienced practitioners regularly follow this procedure in dealing with unique problems, thus saving valuable time for themselves and their clients. As a natural outgrowth of the fact that the Commission is the repository of a vast amount of financial data, the staff is frequently called on to aid in the preparation of studies of current problems such as those involved in formulating the background of legislative proposals.

Amendment of Regulation S-X

During the year a general revision of Regulation S-X, the Commission's principal accounting and auditing regulation relating to the form and content of financial statements filed with it, was accomplished. This regulation was originally adopted in February 1940 after extensive reconsideration of the predecessor requirements theretofore contained in the respective registration and annual report forms.

In the Commission's annual reports for the last two years reference has been made to the relatively infrequent (but important) new provisions added to the regulation since adoption and to the apparent need for a complete reappraisal of the regulation that would include within its scope reconsideration of all rules.[12] These reports reviewed the efforts made, from the preliminary proposal sent out in September 1949 to the formally announced proposal on July 12, 1950, to obtain a wide expression of views not only as to staff suggestions but as to possible amendments to the regulation not sponsored by the staff.

Following the formal announcement of proposed amendments under the Administrative Procedure Act, as to which more than 3,000 persons received copies, again approximately 175 persons commented upon the proposals. The suggestions were carefully considered and in a number of instances formed the basis of changes incorporated in the final amendments. In addition, a special committee of the American Institute of Accountants, at its request, was informally heard by the Commission is support of its views on certain points it believed should be reflected in the revision. The final amendments were pro-

[12] 15th Annual Report, p. 175; 16th Annual Report, p. 156.

mulgated December 20, 1950, in Accounting Series release No. 70.

Among the amendments to Regulation S-X that are of major importance to registrants filing financial statements with the Commission and also to professional accountants whose reports must accompany such statements is a new provision contained in rule 1-01 (a) that in effect makes the previously referred to Accounting Series releases a part of the regulation. Many of such releases contain highly significant statements the applicability of which, under the amended rule, is not now likely to escape the attention of interested persons, and which, it should be clear, continue to reflect considered Commission policy. This is particularly important with respect to release No. 4, to which reference has been made above, because of its controlling provisions in areas where the largest volume of accounting problems fall.

The definitions of terms used in the regulation have now been made complete by bringing into rule 1-02 a substantial group of terms for which previously a reference to other regulations was necessary.

In Article 2 which deals with the certification of financial statements the provisions contained in rules 2-01 (b) and 2-01 (c) relating to the certifying accountant's independence as to a person were extended to any affiliate of the person, and the previous specification, in rule 2-01 (b), as to the interest in such person (or affiliate) that will result in the accountant being considered not independent was changed from "any substantial interest" to "any financial interest," thus conforming the rule to established Commission policy and to the prevailing practice in professional circles.

An important change was effected in rule 3-11 of the regulation. Before amendment the rule exempted public ntility companies from the requirement, and otherwise universal practice, of deducting, on the balance sheet, depreciation, depletion, amortization or retirement reserves from the specific assets to which they apply. The amendment, adopted after full consideration of the conflicting views of interested parties, removes the exemption. Opposition to this change was confined to representatives of the public utility industry who were concerned about the possible effect in certin jurisdictions upon utility rate-making of showing utility plant accounts net of related reserves. The elimination of the exemption was predicated upon the belief that there was no necessary relationship between balance sheets prepared for investors or the public generally and the processes of regulating rates for utility services.

Previous Commission policy as to disclosure of certain commitments is now codified in rule 3-18 of the regulation. In addition to the provision in paragraph (a) for a statement of material firm commitments involving permanent investments and fixed assets there is required by paragraph (b) aappropriate disclosure of annual rentals and other pertinent facts in cases where rentals or obligations under long-term leases are material. The development of policy in this respect was referred to in the annual reports of the last two years.[13]

The rapid expansion of the number of corporate pension and retirement plans that began during World War II and continued to the present time focused considerable attention upon the proper accounting for the much enlarged liabilities and payments associated with the plans. The Commission's views were first discussed in the thirteenth annual report after extensive experience with the many pension plan problems that arose.[14] Later, after additional experience and reconsideration of views, due in part to special problems introduced by the pension-plan results of union-company negotiations in several industries, notably the steel producing industry, the Commission's policy was again indicated in the sixteenth annual report.[15] With this background, and after the benefit of discussion among leaders in finance and of comment prompted by announced proposals, there was included in rule 3-19 (e) the requirement that balance sheets should be accompanied by (1) a brief description of the essential provisions of any such plan; (2) an indication of the estimated annual cost of the plan; and (3) if the plan is not funded or otherwise provided for, a disclosure of the estimated amount that would be necessary to accomplish this.

One of the principal responsibilities of the Commission is to obtain for the investing public financial statements that are the most informative and which are the least likely to mislead, especially, those who are not experienced in the significance of such statements. In previous annual reports[16] reference was made to a problem which has long been under consideration and which has been the subject of repeated exchanges of views between the Commission's staff and representatives of the American Institute of Accountants and other interested parties, namely, the concept of income and the proper form of income or profit-and-loss statement.

The main point of difference has been the propriety of excluding from the determination of Net Income, and the inclusion thereof in Earned Surplus, major items which are

[13] Fifteenth Annual Report, pp. 181-182; Sixteenth Annual Report, pp. 156-157.

[14] Pp. 128-129.

[15] Pp. 157-158.

[16] Eleventh Annual Report, p. 88; Twelfth Annual Report, pp. 117-118; Fourteenth Annual Report, pp. 111-112; Sixteenth Annual Report, p. 159.

extraordinary in nature or which had their origin in prior years. A workable solution to this problem was commented upon as follows in Accounting Series release No. 70, issued on December 20, 1950, which announced the revision of Regulation S-X:

The principal new requirement pertains to Profit and Loss or Income Statements and is contained in Rule 5-03 (a) which states:

> "All items of profit and loss given recognition in the accounts during the period covered by the profit and loss or income statements shall be included."

The inclusion of this requirement, which states a long established policy of the Commission, is deemed necessary because of the not always consistent practice followed by some registrants of excluding certain items from the profit and loss or income statements with the result that the amount shown thereon as net income or loss has been susceptible to misinterpretation by investors. Recognizing that there might be exceptional circumstances which would make it appropriate to deviate from this rule, but keeping in mind the Commission's responsibility for prohibiting the dissemination of financial statements which might be misleading to investors, Rule 5-03 was amended to read:

> "Except as otherwise permitted by the Commission, the profit and loss or income statements filed for persons to whom this article is applicable shall comply with the provisions of this rule." [Underscored phrase added in revision.]

The purpose of this revision is to make clear to registrants that they are not forestalled from giving exceptional treatment to exceptional items when both the representatives of the registrant and the Commission are convinced that such treatment is appropriate.

Notwithstanding this provision, representatives of the Executive Committee of the American Institute of Accountants appeared before the Commission and proposed that either Rule 5-03 (a) be eliminated from the regulation or the requirements with respect to the presentation of the final section of profit and loss or income statements be amended to permit, where appropriate, the exclusion of extraordinary items from those making up the caption net income or loss.

To accomplish this, additional items, described in Rules 5-03 (17) and 5-03 (18), were added to those previously set forth in the regulation, and the last three items of the section pertaining, to profit and loss or income statements (Rule 5-03 now appear as follows:

> "16. Net income or loss.
>
> "17. Special items.—State separately and describe each item of profit and loss given recognition in the accounts, included herein pursuant to Rule 5-03 (a) and not included in the determination of net income or loss (Item 16).
>
> "18. Net income or loss and special items."

Captions 17 and 18 are to be used in those instances where it is believed that the showing of a single unqualified figure of net income or loss might be misconstrued.

CORRESPONDENCE

To the Editor of *The New York Certified Public Accountant:*

The lucid *Codification of Statements on Auditing Procedure* prepared by the Committee on Auditing Procedure of the American Institute of Accountants brings sharply into focus the nature of the auditor's exception in his opinion under certain circumstances.

Members of the accounting profession will recall that the S.E.C. investigation of auditing practices and procedure in the McKesson & Robbins case stimulated the acceptance of *Extensions of Auditing Procedure* (Statement No. 1). *Extensions* formulated the following rules:

> "It is the responsibility of the accountant—and one which he cannot escape—to determine the scope of the examination which he should make before giving his opinion on the statements under review. If in his judgment it is not practicable and reasonable in the circumstances of a given engagement to undertake the auditing procedures regarding inventories and/or receivables set forth in this report as generally accepted procedure and he has satisfied himself by other methods regarding such inventories and/or receivables, no useful purpose will be served by requiring an explanation in his report. If physical tests of inventories and/or confirmation of receivables are practicable and reasonable and the auditor has omitted such generally accepted auditing procedure, he should make a clear-cut exception in his report."

In Statement No. 3, the Committee notes that *Extensions* refers to several types of exceptions and states:

> ". . . when the added procedures are applicable and the auditor has not adopted them but has satisfied himself by other methods, his exception need cover only the omission of the procedures (affecting the scope of the work), without calling into question the inherent fairness of the representations."

In Statement No. 12, the Committee discusses the apparent exemption from disclosure where, in the opinion of the auditor, it is not practicable and reasonable to undertake the extended auditing procedures. The Committee decides to extend the principle of disclosure in such instances, stating,

> "Accordingly, the committee on auditing procedure hereby recommends that hereafter disclosure be required in the short form of independent accountant's report or opinion in all cases in which the extended procedures regarding inventories and receivables set forth in "Extensions of Audit ing Procedure' are not carried out, regardless of whether they are practicable and reasonable, and even though the independent accountant may have satisfied himself by other methods."

The Codification reconsiders the doctrine of Statement No. 3 to the effect that exception may be taken by disclosure of the scope of the audit. In the discussion of the extended procedures, the Committee on Auditing Procedure makes the following statement:

> "In the rare situation in which they are applicable and are not used and other procedures can be employed which will enable him to express an opinion, he should, if the inventories or receivables are material in amount, disclose the omission of the procedures in the general scope paragraph without any qualification in the opinion paragraph with respect to such omission. In deciding upon the 'other procedures' to be employed he must bear in mind that he has 'the burden of justifying the opinion expressed."

It would seem that the reference in the Codification to "the rare situation" is an attempt to restrict the application of the theory of exception by disclosure enunciated in Statement No. 3. Obviously, the concept of the "rare situation" can raise questions in the determination of the "rare situation" more numerous than those the Committee may have intended to settle.

It is respectfully suggested that the spirit of *Extensions of Auditing Procedure,* if not the letter, requires that the failure to apply generally accepted auditing procedures in situations where they are practicable and reasonable, "precludes an expression of opinion on the fairness of the financial statements taken as a whole."

Very truly yours,

Fred Linden, C.P.A.

May 15, 1952.

BOOK REVIEWS

(Continued from page 389)

Volume I (Fundamentals) covers:

Ch. 1- 4: The accounting cycle.

5-10: Merchandising, cash and note transactions, trial balance, adjusting and closing entries, preparation of financial statements.

11-12: Partnerships and control accounts.

13: Inventories of a trading business, including an elementary discussion of fifo, lifo, the retail method of inventory, etc.

14: Accounting for nontrading organizations.

15: General review.

Volume II (Principles) covers:

Ch. 1: Corporations.

2-3: Voucher system; records for large businesses.

4: Prorating expenditures.

5: Manufacturing costs.

6: Surplus

7: Financial statements

8: Dividends

9: Factory ledger system

10: Procedures for bond issues

11: Captial versus revenue expenditures

12: Sinking funds and sinking fund reserves

13: Investments and investment income.

14: Inventories of a manufacturing business, - nine methods of pricing.

15: Control through accounts.

The order of topics in Volume II apears to this reviewer to be somewhat illogical.

Both volumes have tested class problems and questions intended to provide practice in understanding the technical work of the accountant. Diagrams, charts, and illustrated problems are used to help visualize accounting concepts and the flow of values between accounts.

Volume I has 28 problems, 200 questions, and a practice set which starts at the end of Chapter 3. Volume II has 56 problems, 140 questions, and a practice set which starts at the end of Chapter 2.

Both volumes, as already stated, heavily emphasize the techniques of accounting. Accounting theory is minimized. On page 151 (Vol. I) the illustrative income statement continues the fallacy of showing purchases discounts as income and sales discounts as expense. Surprisingly, too, dollar signs are included in the accounts, journals, work sheets, and bank statements.

On an over-all basis, the two volumes represent a competent production for this style of accounting text. But they do have obvious limitations.

ARNOLD W. JOHNSON

Syracuse, New York

AN ADIRONDACK VIEW

The Conference at Saranac Inn is now history. There were four formal sessions and more than four hundred informal sessions. The latter included three for me. I had four questions on my list this year and had sessions with a member of the Buffalo Chapter, a member of the Gotham Chapter, and two members from different chapters. Well, the answers we got were really helpful - we found that, in spite of being fifty miles from a fellow CPA, we could still read the fine print and misunderstand it as well as our confreres.

The only complaint recognized as valid was by the golfers about the black flies. The answer is that these little fellows had just been born a few days and were merely seeking to exist in a harsh world. We have to raise these bugs for the birds and fish to live on. The natives are too few and too tough. So the summer hotels have conferences in June. These conferences bring white and tender-skinned folks from the city for the bugs to get fat on. In July and August the birds and fish live on the bugs and sing and jump for the summer-rate full-paying guests. The hotel owners live off the guests. The help live off the hotel owners. And we have had another successful season. Just another business cycle!

LEONARD HOUGHTON, CPA
Adirondack "Chapter."

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